

The Concept of Transaction as a Restraint on Resale Limitations

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I. INTRODUCTION

Restrictions on the transferability of securities are regulated under state law within a permissive framework.¹ Many business corporation statutes authorize a restriction on transfer to be imposed by the articles of incorporation,² by the by-laws³ or by an agreement among any number of securityholders.⁴ Case law in most states

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1. The law governing restrictions on the transfer of stock is largely a product of state court decisions. Nevertheless, there are currently twenty jurisdictions that have statutes expressly authorizing restrictions on the transfer of shares and imposing notice requirements in order for the restrictions to be valid. *See* ALA. CODE § 10-2A-41 (1975); ARK. STAT. ANN. § 4-26-610 (1987); CONN. GEN. STAT. ANN. § 33-306a (1987); DEL. CODE ANN. tit. 8, § 202 (1983); IDAHO CODE § 30-1-23A (1980); IND. CODE ANN. § 23-1-26-8 (West Supp. 1987-88); KAN. STAT. ANN. § 17-6426 (1983); ME. REV. STAT. ANN. tit. 13-A, § 616 (1964); MICH. COMP. LAWS ANN. §§ 450.1473 (West 1973); MINN. STAT. ANN. § 302A.429 (West 1985); MONT. CODE ANN. § 35-1-617 (1987); NEV. REV. STAT. ANN. § 78.242 (Michie 1986); N.J. STAT. ANN. §§ 14A:7-12 (West 1969); OHIO REV. CODE ANN. § 1701.25 (1985); OKLA. STAT. ANN. tit. 18, § 1055 (West 1986); PA. STAT. ANN. tit. 15, § 1613.1 (Purdon Supp. 1987); R.I. GEN. LAWS § 7-1.1-21.1 (1985); TEX. REV. CIV. STAT. ANN. art. 2.22 (Vernon 1980); VA. CODE ANN. § 13.1-649 (1985); WYO. STAT. § 17-1-132 (1977); *see also* REV. MODEL BUS. CORP. ACT § 6.27 (1984). In fifteen other jurisdictions, the relevant statute provides that restrictions must be noted on the share certificate to be validly imposed. *See* ALA. CODE § 10-2A-41(a) (1975); ARIZ. REV. STAT. ANN. § 10-023(D) (1956); ARK. STAT. ANN. § 10-64-211(B) (1987); CAL. CORP. CODE § 418(a)(1) (West 1975); DEL. CODE ANN. tit. 8, § 202(a) (1983); D.C. CODE ANN. § 29-320 (1954); FLA. STAT. ANN. § 607.067(3) (West 1976); KAN. STAT. ANN. § 17-6426(a) (1983); LA. REV. STAT. ANN. § 12:57(F) (1969); MINN. STAT. § 302A.409 subd. 2 (West 1985); MD. CORPS. & ASS'NS CODE ANN. § 2-211(d) (1985); MASS. ANN. LAWS ch. 156B, § 27(b) (Law. Co-op. 1979); OHIO REV. CODE ANN. § 1701.25(B) (1979); P.R. LAWS ANN. tit. 14, § 1508 (1976); TENN. CODE ANN. § 48-16-208 (Supp. 1987). Ten jurisdictions do not deal with restrictions on the transfer of shares in their corporate statutes: Alaska, Hawaii, Illinois, Missouri, New Mexico, New York, North Carolina, North Dakota, South Carolina, and Wisconsin. *See generally* 6 Z. CRAVITCH, BUSINESS ORGANIZATIONS § 113 (1987); 2 F.H. O'NEAL, CLOSE CORPORATIONS § 7.06 (1971); W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5461.1, et seq. (rev. perm. ed. 1985).

2. *See, e.g.*, ALA. CODE § 10-2A-41(b) (1975); ARIZ. REV. STAT. ANN. § 10-023(D)(3) (1956); ARK. STAT. ANN. § 4-27-627(A) (1987); DEL. CODE ANN. tit. 8, § 202(b) (1983); FLA. STAT. ANN. § 607.164(j)(2) (West 1976); IND. CODE ANN. § 23-1-26-8(a) (West Supp. 1987-88); ME. REV. STAT. ANN. tit. 13-A, § 616(1) (1964); OKLA. STAT. ANN. tit. 18, § 1055 (West 1986); PA. STAT. ANN. tit. 15, § 1613.1 (Purdon Supp. 1987). Case law also supports the creation of transfer restrictions in the articles of incorporation. *See, e.g.*, *Avoyelles Trust & Savings Bank v. Estate of Lilledahl*, 350 So. 2d 1228 (La. 1977); *Ling & Co. v. Trinity Savings & Loan Ass'n*, 482 S.W.2d 841 (Tex. 1972); *Monacan Hills v. Page*, 203 Va. 110, 122 S.E.2d 654 (1961).

3. *See, e.g.*, ALA. CODE § 10-2A-41(b) (1975); ARIZ. REV. STAT. ANN. § 10-023(D)(3) (1956); ARK. STAT. ANN. § 4-27-627(A) (1987); CONN. GEN. STAT. ANN. § 33-306a (1987); DEL. CODE ANN. tit. 8, § 202(b) (1983); HAW. REV. STAT. § 416-80 (1985); IDAHO CODE § 30-1-23A(b) (1980); IND. CODE ANN. § 23-1-26-8(a) (West Supp. 1987-88); ME. REV. STAT. ANN. tit. 13-A, § 616(2) (1964); NEV. REV. STAT. ANN. § 78.242 (Michie 1986); N.D. CENT. CODE § 10-19.1-70 (1985); WYO. STAT. ANN. § 17-1-132 (1977); *Tu-Vu Drive-In Corp. v. Ashkins*, 61 Cal. 2d 283, 38 Cal. Rptr. 348, 391 P.2d 828 (1964); *Rainwater v. Milfield*, 485 S.W.2d 831 (Tex. Civ. App. 1972). But in the absence of authority in the articles of incorporation or statutes, a corporation has no power to adopt bylaws prohibiting or unreasonably restricting transfers. *See, e.g.*, *Strong v. Borward County Kennel Club*, 65 F. Supp. 407 (S.D. Fla. 1946); *Wentworth v. Russell State Bank*, 167 Kan. 246, 205 P.2d 972 (1949); *Lawson v. Household Fin. Corp.*, 17 Del. Ch. 343, 152 A. 723 (1930); N.H. REV. STAT. ANN. § 296.14 (1987) ("No corporation shall make any bylaw to restrain the free sale of shares of its stock; every such bylaw shall be void.").

4. *See, e.g.*, ALA. CODE § 10-2A-41(b) (1975); ARIZ. REV. STAT. ANN. § 10-023(D)(3) (1956); ARK. STAT. ANN. § 4-27-627(A) (1987); CONN. GEN. STAT. ANN. § 33-306a (1987); IND. CODE ANN. § 23-1-26-8(a) (West Supp. 1987-88); ME. REV. STAT. ANN. tit. 13-A, § 616(2) (1964); NEV. REV. STAT. ANN. § 78.242 (Michie 1986); N.J. STAT. ANN. § 14A:7-12 (West 1969); N.D. CENT. CODE § 10-19.1-70 (1985); VA. CODE ANN. § 13.1-649 (1985); WYO. STAT. ANN. § 17-1-132 (1977); *Estate of Riggs v. Midwest Steel & Iron Works*, 36 Colo. App. 302, 540 P.2d 361 (1976); *Eggeson v.*

reaches the same result.⁵ Partnership statutes permit general and limited partnerships contractually to define the rights of a partner to transfer his interest in the partnership.⁶ Whether relying on a statute or on authoritative precedent, issuers of securities and the holders themselves have the discretionary power to place any reasonable restraint on alienation.⁷ The latitude that state law provides is subject to an important qualification. The courts generally have interpreted restraints on

Brower Mfg. Co., 27 Ill. App. 3d 963, 327 N.E.2d 468 (1975); *Thompson v. Anderson*, 209 Kan. 547, 498 P.2d 1 (1972); *Guaranty Laundry Co. v. Pulliam*, 198 Okla. 667, 181 P.2d 1007 (1947); *Rafe v. Hindin*, 29 A.D.2d 481, 288 N.Y.S.2d 662 (1968).

5. See, e.g., *Hodges v. Pittman*, 384 So. 2d 14 (Ala. 1980) (buy-sell agreement upheld because, among other things, the agreement was signed by all of the shareholders, the restrictive provisions were placed on the certificates, and the restraints themselves were reasonable); *In re Estate of Hatfield*, 93 Misc. 2d 472, 403 N.Y.S.2d 172 (1978) (restrictive provision contained in articles of incorporation and noted on share certificates controlled over a provision in a shareholder-decedent will); *Monitor, Inc. v. Hetrick*, 76 Cal. App. 3d 912, 141 Cal. Rptr. 711 (1978) (corporate bylaw provision restricting transfer of shares applied to a division of community property upon divorce); *Ginter v. Palmer & Co.*, 566 P.2d 1358 (Colo. App. 1977) (provision giving corporation, on the death of shareholder, the option to purchase his shares at book value as of the date of death controlled over provision in decedent's will transferring shares to devisee); *Levey v. Saphier*, 54 A.D.2d 959, 388 N.Y.S.2d 644 (Sup. Ct. 1976) (restraint on alienation of shares is enforceable if it effectuates a lawful purpose, is reasonable, and is in accord with public policy); *Yeng Sue Chow v. Levi Strauss & Co.*, 49 Cal. App. 3d 315, 122 Cal. Rptr. 816 (1975) (employee share purchase plan which gave the corporation a repurchase option on the death of the employee-shareholder upheld with court holding that the mere fact that the value of the property had changed since contract was concluded would not warrant a refusal to carry out its terms in the absence of circumstances indicating fraud or bad faith); *Ryan v. J. Walter Thompson Co.*, 453 F.2d 444 (2d Cir. 1971) (regardless of corporate policy underlying the initial use of an option agreement, the agreement would be unenforceable under New York law only if it prevented transfer of the shares, as opposed to merely delaying transfer by giving the corporation a right of first refusal). See also *Fletcher*, *supra* note 1, § 4561.3 n.6.

6. See (1) UNIF. PARTNERSHIP ACT § 18(g), 6 U.L.A. 213 (1969), which provides that "No person can become a member of a partnership without the consent of all the partners." The Uniform Partnership Act has been adopted in every state except Louisiana, the District of Columbia, Guam, and the Virgin Islands. (2) UNIF. LTD. PARTNERSHIP ACT § 2(1)(a)(X), 6 U.L.A. 559 (1969), which provides that a certificate of limited partnership must state, "The right, if given, of a limited partner to substitute an assignee as contributor in his place, and the terms and conditions of the substitution." This Uniform Act has been adopted in sixteen states and the Virgin Islands. (3) REV. UNIF. LTD. PARTNERSHIP ACT § 201(a)(7), 6 U.L.A. 1987 Pocket Part 249, which requires a certificate of limited partnership to set forth, "any power of a limited partner to grant the right to become a limited partner to an assignee of any part of his partnership interest, and the terms and conditions of the power." The Revised Uniform Act has been adopted in the remaining thirty-four states. In 1985 the Revised Uniform Limited Partnership Act was amended by deleting the requirement in § 201(a)(7). The official comment to the amended section notes that the change was made "in recognition of the fact that the partnership agreement, not the certificate of limited partnership, has become the authoritative and comprehensive document for most limited partnerships." Thus, it may fairly be assumed that the practice of allowing limited partnerships to place restrictions upon the transferability of its partners' interests will continue.

7. The reasonableness of a restriction on alienation is a question of law for the courts to decide. See *Palmer v. Chamberlin*, 191 F.2d 532 (5th Cir. 1951). Most courts will uphold a share transfer restriction, imposed by either the issuer or a shareholder, unless the restriction unconditionally prohibits alienation or is otherwise unreasonable. A commonly applied test of reasonableness is whether the purpose served by a restraint is important enough to justify overriding the general policy against restraints on alienation. See, e.g., *Fayard v. Fayard*, 293 So. 2d 421 (Miss. 1974). In *Fayard*, the restriction in question was a "consent restraint," which prohibited transfers without the permission of each shareholder. The court concluded that such a restriction served no reasonable purpose as applied to transfers within the family controlling the close corporation.

Today, restrictions are generally held valid unless they are indefinite, *Hardin v. Rostenthal*, 213 Ga. 319, 98 S.E.2d 901 (1957), or they violate a public policy with respect to matters other than restricting alienation. *Quinn v. Stuart Lakes Club, Inc.*, 80 A.D.2d 350, 439 N.Y.S.2d 30 (1981). Taking advantage of this apparent latitude, issuers and shareholders have put share transfer restrictions to a wide variety of uses. Permissive restriction statutes are particularly useful in the context of a close corporation which might want to use transfer restrictions to, among other things, avoid the possible loss of a corporation's Subchapter S status under the Internal Revenue Code, limit the total number of shareholders, create a ready market for shares by guaranteeing their purchase by either other shareholders or the issuer, see, e.g., *Application of Sirota*, 117 Misc. 2d 1088, 460 N.Y.S.2d 242 (1983), or retain share ownership within a limited group of holders, see, e.g., *Remillong v. Schneider*, 1895 N.W.2d 493 (N.D. 1971) (class of owners restricted to incorporators and their families); *Palmer v. Chamberlin*, 191 F.2d 532 (5th Cir. 1951) (applying Missouri law, restricting class of owners to employees of the issuer). A corporation with relatively few shareholders may also impose transfer restrictions to ensure

alienation very narrowly⁸ and will not enforce them against persons who acquired their securities without notice.⁹ Federal law is in sharp contrast to this approach. Judicial and administrative interpretations of the Securities Act of 1933¹⁰ require parties to certain securities transactions to use transfer restraints, establish the scope and duration of the limitations, and make them enforceable irrespective of actual knowledge.¹¹

The theory of the 1933 Act is that the proper governmental function in connection with transactions in securities is to assist investors and prevent fraud by requiring a disclosure to prospective purchasers of all material facts relative to an offering.¹² The Securities and Exchange Commission (SEC or Commission) and the

that shareholders who wish to retire will be able to liquidate their investment without disrupting corporate affairs. It is not surprising, therefore, that statutes governing stock transfer restrictions are sometimes included in state laws governing close corporations. In fact, some states define a close corporation as one whose issued shares are subject to one or more restrictions on transfer. *See* DEL. CODE ANN. tit. 8, § 342(a)(2) (1983); KAN. STAT. ANN. § 17-7202(a)(2) (1983).

8. *See, e.g.*, *Engel v. Teleprompter Corp.*, 703 F.2d 127 (5th Cir. 1983) (restriction effective when a shareholder proposes to "sell or otherwise dispose of" shares not triggered by an indirect transfer); *Durkee v. Durkee-Mower, Inc.*, 384 Mass. 628, 428 N.E.2d 139 (Mass. 1981) (assignment of shares by order of the probate court pursuant to a divorce decree not a "sale" within the scope of the applicable share transfer restriction); *Stenehiem v. Sette*, 240 N.W.2d 596 (N.D. 1976) (share transfer restrictions waived since they had been ignored repeatedly in connection with earlier transfers of shares; court also relied on the early common-law rule that restrictions on the free marketability of securities are looked on with disfavor); *Estate of Riggs v. Midwest Steel & Iron Works*, 36 Colo. App. 302, 540 P.2d 361 (1976) (restraint on voluntary alienation does not apply to testamentary dispositions); *Earthman's Inc. v. Earthman*, 526 S.W.2d 192 (Tex. Civ. App. 1975) (share transfer restriction not enforceable against a former wife who had been awarded restricted shares pursuant to a divorce decree); *Thompson v. Anderson*, 209 Kan. 547, 498 P.2d 1 (1972) (plaintiff estopped to enforce restriction when he had previously attempted to avoid it); *Remillong v. Schneider*, 185 N.W.2d 493 (N.D. 1971) (transfer restriction not enforceable between shareholders where purpose of restriction was to protect the corporation from outside influence rather than to prohibit an unequal division of share ownership by the sale of shares by one shareholder to another); *Rafe v. Hindlin*, 29 A.D. 481, 288 N.Y.S.2d 662 (1968); *Vogel v. Melish*, 46 Ill. App. 2d 465, 196 N.E.2d 402 (1964); *Berkowitz v. Firestone*, 192 So. 2d 298 (Fla. App. 1966); *Globe Slicing Mach. Co. v. Hasner*, 333 F.2d 413 (2d Cir. 1964). *See generally* 2 F.H. O'NEAL, CLOSE CORPORATIONS § 7.08 (1971).

9. *See, e.g.*, *Erliv v. Nyberg*, 78 Ill. App. 3d 500, 396 N.E.2d 1273 (1977) (transferee had actual knowledge so could not assert bona fide purchaser status); *Norman v. Jerich Corp.*, 262 Or. 259, 501 P.2d 305 (1972); *Ling & Co. v. Trinity Savings & Loan Ass'n*, 482 S.W.2d 841 (Tex. 1972); *see also* *Stenehiem v. Sette*, 240 N.W.2d 596 (N.D. 1976) (shareholder agreement restricting the transfer of stock found unenforceable where party to agreement permitted a third party without actual knowledge of the restriction to change his position in reliance on the possibility of purchasing the unlegended certificates); *cf. F.H.T., Inc. v. Feuerholm*, 211 Neb. 860, 320 N.W.2d 772 (1982) (private shareholder agreement to restrict transfer was binding on the parties even though the certificates did not have the restriction conspicuously noted thereon).

The Uniform Commercial Code provides that unless noted conspicuously on the security a restriction on a transfer imposed by the issuer even though otherwise lawful is ineffective except against a person with actual knowledge of it. U.C.C. § 8-204 (1977). This section is effective in all states. *See, e.g.*, ALA. CODE § 7-8-204 (1975); ALASKA STAT. § 45.08.204 (1986); ARIZ. REV. STAT. ANN. § 47-8204 (1956); COLO. REV. STAT. § 42a-8-204 (1973); DEL. CODE ANN. tit. 6, § 8-204 (1983); HAW. REV. STAT. § 490:8-204 (1985); MASS. ANN. LAWS ch. 106, § 8-204 (Law. Co-op. 1979); MISS. CODE ANN. § 75-8-204 (1972); MONT. CODE ANN. § 30-8-204 (1987); N.C. GEN. STAT. § 25-8-204 (1986); OKLA. STAT. ANN. tit. 12A, § 8-204 (West Supp. 1988); S.D. CODIFIED LAWS ANN. § 57A-8-204 (1980); VT. STAT. ANN. tit. 9A, § 8-204 (1966); VA. CODE ANN. § 18.8-204 (Supp. 1987). This provision was not intended to deal with restrictions imposed by statute or by private agreements among shareholders. Official Comment 6 to U.C.C. § 8-204 (1977).

10. 15 U.S.C. §§ 77a et seq. (1982) [hereinafter the 1933 Act or the Act].

11. Certain resale restraints that are based on administrative interpretations of § 4(1) might not be communicated to or known by a securityholder. *See infra* text accompanying notes 121-31. A person who does not comply with federal restraints in connection with resales of his securities runs the risk of administrative sanctions and a private action for damages by his purchaser under § 12(1) of the Act if he is unable to prove that he did not violate the registration requirements. Section 12(1) is essentially a strict liability provision. A plaintiff is not required to prove scienter, or even negligence, on the part of a defendant. *Lewis v. Walston & Co.*, 487 F.2d 617, 621 (5th Cir. 1973); *Gridley v. Sayre & Fisher Co.*, 409 F. Supp. 1266, 1272 (S.D.S.D. 1976).

12. *See generally* H.R. REP. NO. 85, 73d Cong., 1st Sess. 1-5 (1933); *Report of the Advisory Committee on Corporate Disclosure*, 95th Cong., 1st Sess., Vol. 1, Ch. XIX; (Comm. Print 95-29, 1977); *SEC Disclosure Group*,

courts have determined that in certain instances the legislative goal of investor protection, as embodied in specific regulations, justifies mandatory transfer restrictions. This policy has a dramatic impact on persons wishing to resell unregistered securities. It has yielded a variety of resale limitations that are triggered by either the nature of the person attempting to resell (*i.e.*, an affiliate of the issuer)¹³ or the nature of the transaction in which the holder acquired the securities. Individual resales can be subject to one or more of the following limitations:¹⁴ (1) *holding period*: A holder may be prohibited from reselling certain securities until they have been beneficially owned for a prescribed period of time;¹⁵ (2) *location of sales*: Resales might be confined to residents of a particular geographical area, such as a single state or any place outside the United States;¹⁶ (3) *manner of sale*: A would-be seller might be required to resell in brokers' transactions¹⁷ or be limited to privately negotiated arrangements;¹⁸ (4) *volume*: A quantitative limitation might restrict the amount of securities that are eligible for resale within a fixed period of time;¹⁹ and (5) *availability of information*: The ability to resell in a retail market might depend upon whether the issuer has made publicly available certain specified information.²⁰

Regardless of how beneficial these resale limitations might be in furthering the objectives that Congress set in 1933, the costs associated with them are not insignificant. In addition to the institutional burdens and expenses that are necessarily involved in the implementation of any federal policy on transfer restrictions, this form of regulation creates private costs for the issuer, the securityholder, and professional participants in the capital market. An issuer hoping to acquire capital or other business assets through the sale of its securities will find that transfer restrictions reduce the value of the investment product being offered. An issuer will be forced to compensate prospective buyers for this unattractive characteristic through a lower offering price,²¹ higher dividend or interest rates, or an investment contract sweetener such as a conversion feature or a warrant.²² Even if an issue of restricted securities is successfully placed, the presence of securityholders with resale limitations creates

Disclosure to Investors: A Reappraisal of Federal Administrative Policies Under the '33 and '34 Acts, 10 (1969) [hereinafter Wheat Report]; *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976).

13. See *infra* text accompanying notes 142-46.

14. A less intrusive limitation on resales not included in the text awaits certain securityholders who resell pursuant to 17 C.F.R. § 230.144 (1987), which is discussed *infra* text accompanying notes 113-20. If the securities to be sold exceed 500 shares or if the aggregate selling price of the securities will exceed \$10,000, a notice of the sale must be filed with the Securities and Exchange Commission ("SEC" or "Commission") concurrently with the sale. Rule 144(h).

15. See *infra* text accompanying notes 79-90.

16. See *infra* text accompanying notes 91-104.

17. See *infra* text accompanying notes 113-20.

18. See *infra* text accompanying notes 137-41.

19. See *infra* text accompanying notes 113-20; 126-36.

20. See *infra* text accompanying notes 113-20; 137-41.

21. For a discussion of the factors that enter into the valuation of securities that are not freely tradeable, see Levenson, *Investment Companies and the Private Placement of Securities*, in *PLI, FIRST ANNUAL INSTITUTE ON SECURITIES REGULATION*, 89, 98-100 (R. Mundheim, A. Fleischer & D. Glazer eds. 1970).

22. See *Hearings on Capital Formation 1978-1980 Before the Senate Select Committee on Small Business*, 95th & 96th Congress, Part 3, 593-94 (1978-80) for a summary of testimony by SEC Chairman Harold M. Williams. The Commissioner also reported that resale limitations create (1) "difficulty . . . by issuers in accomplishing new offerings to raise equity capital, thus compounding capitalization problems due to the necessity of repeatedly reverting to debt to satisfy cash needs" and (2) "a higher probability of take-over or mergers as insiders seek to exchange their shares for those of a larger company to obtain liquidity." *Id.*

monitoring costs for the issuer and its legal counsel.²³ An investor who holds securities that are not freely transferable also assumes additional risks and burdens.²⁴ He loses the full range of opportunities that market liquidity provides to a security owner whose circumstances or investment needs have changed. He cannot as easily dissociate himself from an issuer if for any reason he becomes dissatisfied with its management. Where an owner is foreclosed from the retail market and shunted into private transactions, he is likely to encounter a smaller number of potential purchasers and a lower sale price.²⁵ Finally, resale restrictions saddle members of the securities industry with related costs. For an investment banking firm raising capital for an issuer, transfer restrictions on the securities being offered shrink the pool of available investors and make it more difficult to market the issue. Significant amounts of securities that carry a holding period requirement constitute an overhang on the market in that class of security and, therefore, represent for securities dealers a potentially disruptive force. Even a broker who executes sales for a customer assumes added responsibilities when the securities he trades are not freely transferable.²⁶

Despite recent modifications²⁷ the present federal policy of resale limitations continues to impose unnecessary transaction costs. The purpose of this Article is two-fold: to elucidate and explore the theoretical basis for such limitations and to suggest a rationale for reform. It proceeds on the assumption that the federal securities law restricting rights of alienation is a permissible restraint upon an owner's property rights.²⁸ It also assumes that an efficient policy in this area is not one that maximizes public protection on the one hand or securityholder freedom on the other but one that mediates between these goals in a fashion that minimizes the costs of

23. Where a resale limitation is a prerequisite to an issuer's transactional exemption, the issuer has the burden of demonstrating compliance as to the entire transaction, a process that might last for an extended period of time. *See infra* text accompanying notes 73–75. For an indication of the nature of an issuer's policing duties in the context of a nonpublic offering under § 4(2), see SEC Securities Act Release No. 5121 [1970–71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,943 (Dec. 30, 1970), where the Commission discussed the use of legends and stop-transfer instructions.

24. Institutional investors in private placements are especially burdened. *See, e.g., SEC Poised to Loosen Private Placement Trading Rules*, INVESTMENT DEALERS' DIGEST, September 29, 1986, at 12:

A few Street firms set up special groups last year to try to trade privately-placed securities, but their efforts in the past have been hindered by a mire of SEC regulations. The rules are designed, in part, to ensure that private placements—which don't have to be filed for SEC perusal—don't end up being sold to unsophisticated investors.

Generally, institutional investors in private placements have to sign a number of documents agreeing not to resell or make some other kind of distribution of the securities for a certain length of time. Although there are ways to get around some of the restrictions, resale still involves a myriad of paperwork. And in many cases, the institution could be open to possible SEC enforcement action under different aspects of the securities laws. An assessment of the economic plight of a securityholder with restricted securities should not include double-counting. If a holder bargained for a reduced purchase price or other compensating benefit in return for the securities that he cannot freely trade, he is not entitled to sympathy. However, even in this instance a holder might encounter resale burdens for which he was not compensated. As the *infra* text accompanying notes 113–41 indicates, some resale limitations do not originate with the issuer or other transferor and some restraints might not be open to bargain. *See, e.g.,* the transfers that are discussed *infra* in the text accompanying notes 121–25.

25. *See generally* Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 263–65 (1967).

26. *See generally* 7C J.W. HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933, ch. 13 (1988 rev.) [hereinafter J.W. HICKS].

27. The most dramatic changes involve liberalization of volume limitations under rule 144(e) and the termination of certain restrictions on resales by nonaffiliates under rule 144(k). *See infra* notes 113–20.

28. *See generally* Rose-Ackerman, *Inalienability and the Theory of Property Rights*, 85 COLUM. L. REV. 931, 951–53 (1985); Epstein, *Why Restrain Alienation?*, 85 COLUM. L. REV. 970, 973–78 (1985).

liquidating an investment.²⁹ Finally, it assumes that an efficient policy is multidimensional, carefully attuned to the various forms of financing and liquidation and to the different levels of investor sophistication, clearly definable in a manner that allows affected persons to identify and reduce risks, and easily adaptable to fluctuations in market conditions and to changes in law.

This Article asserts that any effort to enforce or to liberalize the 1933 Act resale limitations must take into account the "transaction" concept which is at the heart of the registration and prospectus delivery requirements of the Act. Part II of the Article explains the significance of that concept and discusses its relationship to resale limitations. Part III explores some of the analytical problems that are created when courts and the SEC lose sight of this relationship. Finally, Part IV considers some of the practical implications of the thesis for courts and policymakers charged with enforcing, revising, or eliminating a particular resale limitation.

II. THE TRANSACTION CONCEPT

A. *Securities Transactions in General: An Overview of the Act*

In ordinary parlance a transaction is simply the performance of one or more acts. For those in the commercial world it is a business deal. A transaction involving a security can range from an offer and sale of a single security to a series of offers and sales in an underwritten public securities offering. As used in this sense, the term transaction fails to capture the special nuances that are needed to understand resale limitations under federal securities laws.³⁰ But the nontechnical definition remains useful. Despite the imprecision, it accurately conveys the scope of the registration and prospectus delivery obligations of the 1933 Act.

Section 5 of the Act³¹ implements one of the two major purposes for the statute.³² It protects prospective purchasers of securities by providing them "full and fair disclosure of the character of securities" to be sold.³³ The registration procedure contemplated by section 5 calls for the filing of a registration statement (including a disclosure document referred to as a "prospectus")³⁴ with the SEC, the review of the filed materials by the SEC staff, and the correction of all deficiencies in the documents by the registrant prior to the effective date of the registration statement.³⁵ Section 5 also contemplates that a copy of the prospectus be given to each investor

29. This principle is an adaptation of a normative statement by Richard A. Posner that he made with respect to corporation law and creditor protection. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 509 (1976).

30. A discussion of the technical meaning that the term "transaction" has under the Act is contained *infra* in the text accompanying notes 63-76.

31. 15 U.S.C. § 77e (1981).

32. The preamble to the Act states: "An Act. To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes." Securities Act of 1933, Pub. L. No. 22, § 1, 48 Stat. 74, c. 38 (1933).

33. *Id.*

34. "Registration statement" is defined in § 2(8). 15 U.S.C. § 77b(8) (1981). "Prospectus" is defined in § 2(10). 15 U.S.C. § 77b(10) (1981).

35. The procedure for filing a registration statement is set forth in § 6 of the Act. 15 U.S.C. § 77f (1981).

prior to sale, or in some cases, at the time of delivery of the security after sale.³⁶ However, these obligations were not intended to reach every securities transaction. The legislative relief came in the form of exemptions that are set forth in sections 3 and 4.³⁷ Of particular importance to this Article are those exemptions designed for certain "transactions."³⁸ Before turning to the word as a term of art, a further preliminary issue must be resolved. Who is subject to the registration requirements?

The Securities Act of 1933 reflects a distinction Congress made between two extreme forms of securities transactions. At one terminus is the full-scale public distribution of a substantial block of securities that is underwritten and orchestrated by investment bankers and carried to fruition by a select group of broker-dealers. The pressures of solicitations, recommendations, and other sales activity accompanying such an offering of securities can force members of the public into imprudent or improvident investment decisions that are made without the benefit of accurate information concerning the issuer, its management, and the realities of its immediate future. In the opinion of Congress, prospective investors who are confronted with these pressures deserve the special protections that are provided by the registration and prospectus delivery requirements of the Act. The second extreme is the routine sale of a few securities by a person who commands no influence or control over the issuer of the securities he sells. Ordinary trading by individual investors is devoid of the promotional pressures that characterize a public offering. Consequently, the justification for imposing the registration burdens of the Act on the seller does not arise. The distinction between *distribution* of securities and *trading* in securities, as just described, is admittedly imprecise, but is nonetheless useful. For even in its grossest form the distinction explains the interrelationship of sections 5, 4(1), and 2(11), and, in turn, explains the presence of the other transactional exemptions under the Act.

The regulatory net of section 5 reaches far afield. The obligations of that statutory provision apply to "any person" who uses the mails or other channels of interstate commerce to offer "or" sell or "to" buy a security, to sell a security, or to deliver a security after sale. Without the presence of a qualifying provision, section 5 would encompass all securities transactions by "any person,"³⁹ from an underwritten public offering to an ordinary trade of a single security. However, section 4(1)

36. The prospectus-delivery requirements are a function of exceptions set forth in § 4(3) of the Act. 15 U.S.C. § 77d(3) (1981).

37. 15 U.S.C. §§ 77c & d (1981).

38. Although the statutory heading for § 3 is "Exempted Securities," only securities covered by §§ 3(a)(2) through 3(a)(8) are accorded the privileges of exempted securities. 15 U.S.C. § 77c(2)-(8) (1981). These exemptions turn on the intrinsic nature of the issuer or the character of the security itself which, in turn, justifies the belief that further governmental regulation would be improper or superfluous. As a result, these exemptive provisions eliminate the need to determine whether the exempted securities are being distributed or traded or whether the person selling them is an issuer, underwriter, or dealer. See generally Throop & Lane, *Some Problems of Exemption Under the Securities Act of 1933*, 4 LAW & CONTEMP. PROB. 89, 92-93 (1937).

In addition to enacting exemptions for certain classes of securities, Congress identified certain transactions which, for a variety of reasons, it believed did not justify full and detailed compliance with § 5. Sections 3(a)(1), 3(a)(9), 3(a)(10), 3(a)(11), 3(b), 3(c), and all of the subparagraphs of § 4 provide exemptions from the registration requirements for the particular securities transactions. 15 U.S.C. §§ 77c(a)(1), (9), (10) & (11), (b), & (c) & (d)(1), (2), (3), (4), (5), & (6) (1981).

39. 15 U.S.C. § 77c(c) (1981). The term person is broadly defined in 15 U.S.C. § 77b(2) (1981).

of the Act effects the distinction that Congress intended between distribution of securities and trading in securities by removing the application of section 5 from any securities transaction "by any person other than an issuer, underwriter, or dealer."⁴⁰ Stated differently, section 4(1) exempts all transactions except those by an issuer, underwriter, or dealer.

To appreciate how section 4(1) preserves the desired goals of section 5 for a distribution while it simultaneously bestows a freedom from registration for ordinary trading, one must understand the exceptions included in section 4(1), especially the term "underwriter," defined by section 2(11).⁴¹ In the process of understanding the limitations expressly provided for in section 4(1), one will also acquire an appreciation for the need that certain persons have to investigate the strengths and weaknesses of other exemptions under the Act. The following analysis of section 4(1) is designed to produce both insights. It is organized in terms of these categories of possible sellers of unregistered securities: (1) the issuer; (2) a person in a control relationship with the issuer (affiliate of an issuer); (3) a person who does not enjoy a controlling influence upon the issuer (nonaffiliate); and (4) a person who is engaged in the business of buying or selling securities as agent or principal (a broker-dealer).

1. Issuer

The first exception from the section 4(1) exemption is any transaction "by . . . an issuer."⁴² An issuer, as the source of securities, is more likely to distribute its securities to the public, directly or indirectly, and less likely to trade in those securities as an ordinary investor. Consequently, transactions by an issuer do not need, nor do they qualify for, the exemption designed for trading. If an issuer wishes to sell unregistered securities, it must rely upon an exemption other than section 4(1). Possible exemption candidates are sections 3(a)(9), 3(a)(10) and 3(a)(11), Regulations A⁴³ and D⁴⁴ under section 3(b), and sections 4(2) and 4(6).

2. Affiliate of Issuer

The policy of the Act, as implemented by section 5, is to provide for "full disclosure of every essentially important element" pertaining to a distribution of securities.⁴⁵ This policy is equally applicable to the distribution of a new issue and to

40. 15 U.S.C. § 77d(1) (1981).

41. Section 2(11) states:

The term "underwriter" means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

15 U.S.C. § 77b(11) (1981).

42. 15 U.S.C. § 77d(1) (1981). "Issuer" is defined by § 2(4) to include "every person who issues or proposes to issue any security." 15 U.S.C. § 77b(4) (1981).

43. 17 C.F.R. § 230.251-261 (1987).

44. 17 C.F.R. § 230.501-505 (1987).

45. *Report of Committee on Interstate and Foreign Commerce*, H.R. REP. No. 85, 73d Cong., 1st Sess. 3 (1933).

a subsequent redistribution of securities that are issued and outstanding. The following excerpt from the House report on the bill that eventually became part of the Act, as adopted, explains the legislative decision for requiring registration in connection with so-called secondary distributions through underwriters by controlling security holders (affiliates).⁴⁶

All the outstanding stock of particular corporation may be owned by one individual or a select group of individuals. At some future date they may wish to dispose of their holdings and to make an offer of this stock to the public. Such a public offering may possess all the dangers attendant upon a new offering of securities. Wherever such a distribution reaches significant proportions, the distributor would be in the position of controlling the issuer and thus able to furnish the information demanded by the bill. This being so, the distributor is treated as equivalent to the original issuer and if he seeks to dispose of the issuer through a public offering, he becomes subject to the act.⁴⁷

Having decided to subject an affiliate to the registration requirements of the Act, Congress had to translate the policy decision into the language of the statute. Instead of employing restrictions directly applicable to affiliates, Congress opted for a regulatory scheme that affected all distributions, including those effected by affiliates. This indirect control of affiliates is reflected in the operation of sections 5, 4(1), and 2(11) of the Act. Section 5, it should be recalled, applies to the offer and sale of a security by "any person."⁴⁸ Section 4(1), on the other hand, provides an exemption from section 5, but only to transactions by "any person other than an . . . underwriter."⁴⁹ The term "underwriter," as used in section 4(1), is defined by section 2(11) of the Act as "any person who . . . sells for an issuer in connection with the distribution of any security. . . . As used in this paragraph the term "issuer" shall include . . . any person . . . controlling . . . the issuer."⁵⁰

Whenever an affiliate's sales reach the "significant proportions" referred to in the legislative history of the Act,⁵¹ the transaction is deemed to involve a distribution for purposes of section 2(11). Any broker-dealer or other person who assists an affiliate in a distribution becomes an "underwriter" since he is one who "sells for an issuer" (a term that is equated with the term affiliate for purposes of section 2(11)) "in connection with the distribution of any security."⁵² As a result of the underwriter status of those persons who assist him in the public offering, the affiliate himself, as a person who is "engaged in steps necessary to the distribution of security issues,"⁵³ is denied the benefit of a section 4(1) exemption even though he might not fall within the section 2(11) definition. An affiliate who is either an underwriter or plays an essential role in the distribution of a security issue is foreclosed from claiming a

46. The term "affiliate" as defined by the SEC in 17 C.F.R. § 230.405 (1987) includes a person who directly or indirectly controls the issuer. For a detailed discussion of the concept, see *infra* text accompanying notes 272-94.

47. H.R. REP. NO. 85, *supra* note 45, at 13-14.

48. 15 U.S.C. § 77e(c) (1981).

49. 15 U.S.C. § 77d(1) (1981).

50. 15 U.S.C. § 77b(11) (1981), *supra* note 41.

51. H.R. REP. NO. 85, *supra* note 45, at 13-14.

52. 15 U.S.C. § 77b(11) (1981).

53. SEC v. Chinese Consol. Benevolent Ass'n, 39 F. Supp. 85 (S.D.N.Y. 1940), *rev'd*, 120 F.2d 738, 741 (2d Cir.), *cert. denied*, 314 U.S. 618 (1941), discussed *infra* in the text accompanying notes 65-72.

section 4(1) exemption and must either register his securities or look elsewhere in the Act for a possible exemption.

A logical but misleading inference can be drawn from the foregoing analysis of sections 4(1) and 2(11), as applied to affiliates. Where the securities in an affiliate's transaction do not reach significant proportions, a distribution, as interpreted for purposes of section 2(11), would be deemed to be nonexistent. Without a distribution, no one, including an affiliate, can become an underwriter.⁵⁴ Therefore, one might conclude, section 4(1) is always available under such circumstances.

The problem with this conclusion is that it fails to account for the difference that exists under the Act between restricted and unrestricted securities. It also ignores the possibility that recent sales of securities by persons closely related to the affiliate will be attributed to him and will thereby increase his volume of securities to significant proportions. Assuming, however, that no sales are attributable to an affiliate who intends to rely upon section 4(1) for the sale of an insignificant amount of securities, the exemption is available, but only if the securities are unrestricted. If the securities in the transaction are restricted, section 2(11) reemerges as a possible bar to a section 4(1) exemption, thereby forcing the seller to consider Rule 144⁵⁵ and other alternative exemptions.

3. Nonaffiliate of Issuer

A nonaffiliate, by definition, is a person who does not possess the power to direct or cause the direction of the management and policies of an issuer of securities.⁵⁶ As a noncontrolling person, he is unlikely to qualify as an underwriter within the meaning of section 2(11) when he sells unregistered securities in ordinary brokerage transactions or in privately negotiated sales. In such transactions, neither the broker-dealer nor the purchaser who is involved in the nonaffiliate's transaction would be selling for or buying from an issuer (*i.e.*, control person) for purposes of section 2(11). As a result, in most situations, a nonaffiliate's sales of securities can be properly described as trading, the type of transaction section 4(1) permits without the use of a prospectus. The kind of transaction that creates difficulties under section 4(1) for a nonaffiliate is the offer and sale of so-called "restricted" securities. The concept of restricted securities grows out of the basic distinction in the Act between a distribution and a trade.

Primary and secondary distributions of unregistered securities can be effected in a variety of ways. The issuer or major securityholder who makes a public offering might utilize the special skills of an investment banker or a broker-dealer who will either purchase the securities as principal for resale at a profit or will market the securities for the seller as agent for a commission or fee. In either case, the

54. "Underwriter," as defined by § 2(11) of the Act, includes any person who is purchasing with a view to, or offering or selling in connection with "the distribution of any security" or who has a direct or indirect participation in "any such undertaking," *i.e.*, "distribution." *Supra* note 41.

55. 17 C.F.R. § 230.144 (1987). For an overview of rule 144, see Steinberg & Kempler, *The Application and Effectiveness of SEC Rule 144*, 49 OHIO STATE L.J. 473 (1988).

56. 17 C.F.R. § 230.405, defines "affiliate." See *infra* text accompanying notes 283-94.

professional participant in the distribution qualifies as an underwriter under section 2(11). The activities performed by an investment banker or broker-dealer might also be rendered by one or more nonprofessionals. In order to prevent issuers or affiliates of issuers from circumventing the requirements of section 5 by distributing unregistered securities through nonprofessionals, Congress defined "underwriter" to include "any person who has purchased from an issuer with a view to . . . the distribution of any security."⁵⁷ The SEC has emphasized the importance of this phrase in section 2(11) by defining as "restricted securities" any securities acquired directly or indirectly from the issuer or an affiliate of that issuer in a transaction not involving a public offering.⁵⁸ To protect investors against an indirect distribution, the Commission requires the owner of restricted securities to hold them for an appropriate length of time and then to resell them in such limited quantities and in such a manner as not to disrupt the trading markets.⁵⁹

4. Broker-Dealer

Any person who is engaged either for all or a significant part of his time, as agent or principal, in the business of buying, selling, or otherwise trading in securities is defined by the Act as a "dealer."⁶⁰ An important question faced by Congress in 1933 was whether to subject a dealer to the registration requirements of the Act for every one of the countless transactions he effects on a daily basis in his business.

A dealer is, by occupation, a natural link in the chain of transactions through which securities move from an issuer or an affiliate of an issuer to the public. Where a distribution is made pursuant to an effective registration statement, dealers are a logical choice for assisting in the delivery of prospectuses. Where a distribution involves sales of unregistered securities in violation of section 5, some dealers will find themselves, wittingly or unwittingly, playing a key role as participants in a public offering. If dealers are to share in the duties of delivering prospectuses and if the exemption in section 4(1) is to be preserved for ordinary trading, transactions by dealers require special regulation. These legislative judgments are reflected in the specific exception in section 4(1), which removes the exemption from any transaction by a dealer,⁶¹ and in sections 4(3) and 4(4), which are technical exemptions tailored especially to the realities of the securities markets and the objectives of section 5.⁶²

The preceding discussion contains a potential red herring. By focusing on persons who are subject to the registration requirements of the Act, the survey might create an impression that the exemptive provisions are tailored to categories of prospective sellers and that, therefore, it is the person who is exempted. While it is true the exemptions are designed for particular persons they are applicable only to

57. 15 U.S.C. § 77b(11) (1981).

58. 17 C.F.R. § 230.144(a)(3) (1987).

59. 17 C.F.R. § 230.144 (1987). For a discussion of rule 144, see *infra* text accompanying notes 113-20.

60. 15 U.S.C. § 77b(12) (1981).

61. 15 U.S.C. § 77d(1) (1981).

62. 15 U.S.C. §§ 77d(3) & (4) (1981). See generally 7C J.W. HICKS, *supra* note 26, Chs. 12 & 13.

transactions. It is for this reason that the term transaction warrants particular attention.

B. *Transaction: The Technical Meaning*

A transaction is not subject to section 5 if it qualifies for one of the exemptions under sections 3 or 4.⁶³ The issue then, for a prospective seller, is to determine the specific activities that must be tested against the requirements of a possible transactional exemption. Despite the relevance of the term to the regulatory scheme, neither the Act nor any administrative rule defines it.⁶⁴ One possible inference that can be drawn from the absence of a definition is that for both Congress and the SEC the term has no special meaning. The decision by the Second Circuit Court of Appeals in *SEC v. Chinese Consolidated Association*⁶⁵ laid to rest any such notion.

The Chinese Consolidated Benevolent Association was a New York corporation organized for benevolent and patriotic purposes, with a membership of approximately 25,000 Chinese persons. On September 1, 1937, the government of the Republic of China authorized the issuance of \$500 million in four percent Liberty Bonds; on May 1, 1938, the Republic of China authorized the issuance of \$50 million in five percent U.S. Dollar Bonds. In October 1937, the Association established a General Relief Fund Committee which had no official or contractual connection with the government of China or any branch thereof, to solicit and receive funds from members of the Chinese communities in New York, New Jersey, and Connecticut and from the general public in those states, for transmittal to China for general relief purposes. The Committee proceeded to advertise the sale,⁶⁶ collect funds, and transmit the payments (approximately \$600,000) to the Bank of China in New York, which then transmitted the funds to its branch in Hong Kong with instructions to make purchases for the account of the various customers. The Hong Kong bank returned the bonds by mail to the New York agency of the Bank of China, which in turn forwarded the bonds by mail to the purchasers at their mailing addresses. In some instances, the address given by individual purchasers was the Association. In those situations, the New York branch of the Bank of China sent the bonds to the individual purchaser in care of the Association. The members of the Committee received no compensation, either from

63. See *supra* note 38.

64. The efforts by the SEC to provide issuers with objective criteria or safe harbor rules for avoiding integration of offers or sales do not represent a definition of "transaction." See, e.g., 17 C.F.R. §§ 230.147(b), 230.152 & 230.502(a) (1987); SEC Securities Act Release No. 4434 (Dec. 6, 1961), 1 Fed. Sec. L. Rep. (CCH) ¶ 2270, 2272 at 2608. These administrative pronouncements are intended to indicate when offers or sales by an issuer, preceding, accompanying, or following an offering allegedly for a separate purpose, will not be integrated with that offering. They do not address the issue of when each of the separate offerings commences or terminates. For a discussion of the doctrine of integration, see, e.g., R. JENNINGS & H. MARSH, *SECURITIES REGULATION, CASES AND MATERIALS* 440-44 (6th ed. Foundation 1987); *American Bar Association, Committee on Federal Regulation of Securities, Integration of Securities Offerings: Report of the Task Force on Integration*, 42 BUS. LAW 595 (1986); Shapiro & Sachs, *Integration Under the Securities Act: Once an Exemption, Not Always*, 31 MD. L. REV. 3 (1971).

65. 120 F.2d 738 (2d Cir. 1941), cert. denied, 314 U.S. 618 (1941).

66. The Committee used mass meetings, advertising in newspapers distributed through the mails, and personal appeals to urge the members of Chinese communities in New York, New Jersey, and Connecticut to purchase the Chinese government bonds, and offered to accept funds from prospective purchasers for delivery to the Bank of China in New York as agent for the purchasers. 120 F.2d 738, 739 (2d Cir. 1941).

the persons who transmitted money or from the Bank of China, the Chinese government, or from any other source in connection with its activities. No registration statement was filed for any of the Chinese bonds advertised through the mails for sale. On June 12, 1940, the SEC filed a civil suit against the Association to enjoin it from selling unregistered bonds in violation of the Securities Act of 1933.

The Commission contended that by advertising the bond offering, and soliciting purchases and receiving funds from the individual purchasers, the Association was selling securities in violation of section 5. The District Court for the Southern District of New York rejected the SEC's request for an injunction and granted the Association's motion for judgment on the pleadings. It found that the Association was not an agent of the issuer, the Republic of China, and therefore, was not an underwriter for the issuer.⁶⁷

The Court of Appeals for the Second Circuit, in a majority opinion written by Augustus Hand, reversed the lower court, concluding that the Association was a section 2(11) underwriter.⁶⁸ In acceding to the Commission's request for injunctive relief, the court fashioned an alternative theory for withholding the section 4(1) exemption from the defendant.⁶⁹ The court concluded: "Even if the defendant is not itself an issuer, underwriter, or dealer, it was participating in a transaction with an issuer, to wit, the Chinese Government."⁷⁰ In explaining its construction of section

67. 39 F. Supp. 85, 89 (1940).

68. 120 F.2d 738, 741 (1941).

69. Judge Hand's alternative grounds for denying the Association a § 4(1) exemption—its significant participation in the issuer's violation of § 5—was forcefully advanced by the SEC in its brief to the court. The major thrust of the Commission's suit against the Association was that § 4(1), by its terms, offered two reasons for excluding the defendant's activities: (1) the admitted facts disclosed a "transaction by an issuer [*i.e.*, the Republic of China]," and (2) the defendant was an underwriter. The Commission explained the first of these two reasons, in part:

As pointed out above, the purpose of Section 4(1) is to exempt ordinary trading transactions, not distributions. To achieve this purpose, the section excludes from the exemption transactions by an issuer.

The issuer in this case is the Republic of China. Each completed transaction in the distribution of the Chinese bonds includes: a solicitation by the defendant of an offer to buy; an offer to buy made by an individual purchaser; and the acceptance of that offer by the Chinese Government. There is no separate and distinct transaction carried through by the defendant; its solicitation merely initiates a transaction to be completed by the Republic of China. Since each completed transaction is one effected by an issuer, the transaction is not exempt under Section 4(1) of the Act.

The defendant argues that it is not itself an issuer or an underwriter and that, therefore, Section 4(1) exempts its solicitation of offers to buy. This argument assumes that the exemption applies to component parts of a single transaction, while excluding other parts. There is no support for this position in the statute. On the contrary, the Act prohibits "sales" (which as defined include solicitations of offers to buy) in all transactions by an issuer regardless of the character of person making the solicitation. If Congress had intended to exempt all persons other than issuers, underwriters, or dealers regardless of their participation in a transaction by an issuer, it seems that it would have been simple to reach this result by drafting Section 4(1) to read:

"The provisions of Section 5 shall not apply to any of the following persons:

(1) Persons other than issuers, underwriters, or dealers."

Congress carefully distinguished between the terms "classes of securities," "transactions," and "persons," as is evidenced by Sections 3, 4, and 5 of the Act. It therefore obviously intended to exempt "transactions," rather than "persons," when it used the word "transaction" in Section 4(1).

To interpret Section 4(1) as granting an exemption to this defendant would mean that the courts would be powerless to restrict persons knowingly performing essential functions in the distribution of securities by an issuer.

SEC Brief, *SEC v. Chinese Consol. Benevolent Ass'n*, *supra* note 65, at 15–16 [hereinafter *SEC Chinese brief*].

The Commission adhered to this same position in its brief in opposition to the Association's writ of certiorari to the U.S. Supreme Court. *Id.* at 7–9.

70. 120 F.2d 738, 741 (1941).

4(1), the court responded to the Association's argument that Congress had carved out only three exceptions to the general trading exemption and the category of participants was not one of them.

The court began by noting that the transaction, initiated by the Republic of China, needed an effective registration statement or an appropriate exemption other than section 4(1) and that it embraced more than the actual sales of its securities. The issuer's transaction included the solicitation of offers to buy, "the offers themselves, the transmission of the offers and the purchase money through the banks to the Chinese government, the acceptance by that government of the offers and the delivery of the bonds to the purchaser or the defendant as his agent." The Association's role in this transaction was significant. According to Judge Hand, the Association participated in the unregistered distribution by soliciting orders, obtaining the cash from the purchasers, and causing both to be forwarded to the issuer's agents. Contrary to the Association's belief, the defendant's participation could not be isolated from the entire transaction and, so separated, be given the protection of section 4(1). As Judge Hand reasoned:

[T]he argument on behalf of the defendant incorrectly assumes that Section 4(1) applies to the component parts of the entire transaction we have mentioned and thus exempts defendant unless it is an underwriter for the Chinese Republic. Section 5(a)(1), however, broadly prohibits sales of securities irrespective of the character of the person making them. The exemption is limited to "transactions" by persons other than "issuers, underwriters or dealers."⁷¹ It does not in terms or by fair implication protect those who are engaged in steps necessary to the distribution of security issues. To give Section 4(1) the construction urged by the defendant would afford a ready method of thwarting the policy of the law and evading its provisions.⁷²

The interpretation of the term "transaction," as enunciated by the Second Circuit in the *Chinese Consolidated* case, falls short of a formal definition. However, even if the court had not been constrained by the particular facts and statutory provisions in dispute, it could not have fashioned a construction that applies across the board. It is an elusive concept that perhaps is definable only through its characteristics. Judge Hand's opinion captured two of four key elements of the concept as it relates to exemptions from the requirements of section 5. The other two elements follow logically from them.

First, a transaction consists of more than the aggregate offers and sales of securities. The scope of section 5 and the breadth of the terms "offer" and "sale," as defined in section 2(3) and as applicable to section 5, clearly demand regulations that reach other activities as well.⁷³

Second, a transaction has a temporal dimension that is determined by the exemption being invoked. Some sales are completed within minutes, while others may extend over a period of days, months, or even years. However long it takes a person to sell securities, he must comply with all of the terms and conditions of the

71. *Id.*

72. *Id.*

73. *Id.* at 740.

claimed exemption. The duration of any transaction is fixed by those prerequisites and by the general purpose of the exemption.⁷⁴

Third, a transaction is indivisible. Offers and sales within the transaction may not be separated so that some will meet the requirements of one particular exemption while the others, which are ineligible for that exemption, are earmarked for another exemption.⁷⁵

Fourth, the quality of earlier and distinct transactions is immaterial. For example, a person who has acquired securities in an exempted transaction may not rely upon the exempt status of the earlier transaction to help him in a subsequent resale. Similarly, a person who purchased securities sold pursuant to an effective registration statement is not permitted to ignore the mandates of section 5 upon resale on the grounds that his seller fully complied with the registration requirements of the Act. In both situations, the investor's resale involves a separate transaction that must either comply with the requirements of section 5 or be protected by an appropriate exemption. Conversely, a person who has acquired securities from an issuer or a securityholder who sold the securities to him in violation of section 5 is not treated as an owner of "tainted" securities that can never be resold in compliance with the Act. Assuming that he is not in a controlling relationship with the issuer, and does not function as an underwriter, such a person is viewed as an independent participant in the securities market and may resell the securities in a registered offering or in reliance upon an appropriate exemption.⁷⁶

The second of these four characteristics—the duration of a transaction as controlled by the conditions and purpose of an exemptive rule or provision—leads to the topic of resale limitations.

C. *The Relationship Between the Concept of Transaction and Resale Limitations*

From the securityholder's perspective, resale limitations can arise either because of the transaction in which the holder acquired his securities or because of the transaction that he intends to initiate. In the first of these situations, the acquiring transaction, resale limitations might exist because the transferor, either the issuer or another securityholder, was not permitted legally to proceed with its transaction unless it restricted the transferability and resale of the securities involved. Even where the transferor was not obligated to restrict resales, a holder might discover resale restrictions emerging from his acquiring transaction because of SEC policy that addresses him but not his transferor. Resale limitations can also originate in connection with a securityholder's transferring transaction. This problem is confined to affiliates.

74. *Id.* at 740–41. See also *SEC v. Brooklyn Manhattan Transit Corp.*, 1 S.E.C. 147, 162 (1935), where the Commission stated that "[t]he point at which such distribution is completed is a question of fact to be determined in the light of all the circumstances of the offering."

75. For a discussion of the doctrine of integration, which is designed to prevent segmenting a single transaction, see the authorities cited *supra* in note 64.

76. 7 J.W. Hicks, *supra* note 26, § 1.101[3].

The distinction between acquiring and transferring transactions provides a useful framework for organizing resale limitations. As a person directly affected by resale limitations, the securityholder has a major interest in policy determinations that underlie restraints on his property rights. It seems appropriate, therefore, to approach the topic from the holder's perspective. More importantly, the distinction brings into sharper focus the relationship that exists between transactions and resale limitations. Congress in 1933 did not construct a monolithic policy on secondary sales that might explain the transfer restraints that are presently in place. It enacted a statute which, as construed by courts and the SEC, has yielded a multifariousness of limitations, with each serving a different purpose.⁷⁷ Determining which, if any, of these restraints is appropriate in a specific transaction depends on the objective of the statutorily based regulations that govern that transaction. The use of resale limitations is confined almost exclusively to unregistered offerings in which the seller must qualify his transaction under one of the exemptive rules or provisions.⁷⁸ In these cases the pertinent regulatory objective is found in the exemption that the seller claims. Thus, the only way for one to assess the efficacy and validity of a particular resale limitation is to trace it back to its originating transaction and to ask whether the limitation contributes to the objective of the exemption that the seller invoked for that transaction. The discussion that follows arranges resale limitations in terms of the two types of originating transactions, aligns the limitations with the relevant exemptions, and articulates the traditional justification for imposing restraints in particular exempted transactions.

1. *Acquiring Transactions*

a. *Issuer as Source of Limitations*

A person who purchases securities in a registered public offering will not discover resale restrictions imprinted on his stock certificate or other evidence of ownership interest. He might receive this message, however, where the issuer structures its transaction to qualify for a transactional exemption.

Issuer-initiated limitations can involve either a required holding period or a prohibition on trading outside a prescribed geographic area. Holding period requirements attach to securities that are sold pursuant to private placements under section 4(2)⁷⁹ or 4(6)⁸⁰ or in limited offerings under rules 504⁸¹ or 505⁸² of Regulation D.

77. See *supra* text accompanying notes 14–20.

78. The discussion of resale limitations *infra* text accompanying notes 215–36 relates to registered offerings.

79. Rule 506 provides a safe harbor for issuers seeking to rely upon § 4(2). 17 C.F.R. § 230.506 (1987). It requires that the issuer impose resale limitations. 17 C.F.R. §§ 230.506(b)(1) & 502(d) (1987).

80. Section 4(6) does not explicitly require a holding period but it achieves this result with the statutory language which extends the exemption to offers and sales by an issuer “solely” to one or more accredited investors. 15 U.S.C. § 77d(6) (1981).

81. 17 C.F.R. §§ 230.504(b)(1) & 230.502(d) (1987). Rule 504(b)(1) dispenses with a holding period requirement where an issuer's offers and sales are made exclusively in one or more states providing for registration and delivery of a disclosure document. See generally 7A J.W. Hicks, *supra* note 26, § 7.05[3][c][ii].

82. 17 C.F.R. §§ 230.505(b)(1) & 230.502(d).

As construed by the SEC, all of these securities are deemed to be restricted⁸³ and, if they are to be resold in reliance upon that rule, must be beneficially owned for a period of two years prior to resale.⁸⁴ The two-year holding period limitation is predicated on the assumption that a purchaser in any of these transactions ought to be at risk for a reasonable period of time before he can sell without registration.⁸⁵ However, the purpose it serves in these unregistered offerings is not the same.

Sections 4(2) and 4(6) provide transactional exemptions for an issuer that confines its offers and sales to persons who because of sophistication, wealth, or economic bargaining power do not need the benefits offered by registration.⁸⁶ In either of these nonpublic offerings, the holding period requirement is designed to prevent an allegedly private offering from spilling over to persons who need the protections of registration and disclosure.⁸⁷

Unlike sections 4(2) and 4(6), the exemptions provided by rules 504 and 505 permit an issuer to offer its securities publicly without regard to the sophistication or experience of potential investors. But some features of a public offering have been eliminated. Section 3(b), which is the source for these exemptive rules, authorizes the Commission to create additional transactions if it finds that registration is not necessary for the protection of investors "by reason of the small amount involved or the limited character of the public offering."⁸⁸ The limitations on resale, together with the other conditions of rules 504 and 505, guarantee that the offerings retain the "limited character" that the statute requires. In the case of rule 504 transactions, the resale limitation and the prohibition on general advertising are the only checks on an otherwise open invitation to small companies to raise a maximum of \$500,000 without any disclosure obligations.⁸⁹ The condition in rule 505 relating to resales ensures that the limitation on the number of purchasers in rule 505(b)(2)(ii) is meaningful.⁹⁰

Limiting resales to a particular geographical area is part of an issuer's obligations where it sells unregistered securities in an intrastate offering pursuant to section 3(a)(11)⁹¹ or in a foreign offering in accordance with guidelines set forth in SEC Release No. 4708.⁹² The intrastate exemption requires not only that the securities be offered and sold in a single state, but also that they come to rest in the hands of persons resident within the state.⁹³ Although intrastate trading among

83. 17 C.F.R. § 230.144(a)(3) (1987); SEC Securities Act Release No. 6389, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,106 at 84,921 (March 8, 1982) where the SEC characterizes securities acquired in a § 4(6) transaction as restricted.

84. 17 C.F.R. § 230.144(d)(1) (1987).

85. SEC Securities Act Release No. 5223, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,487 at 81,056 (January 11, 1972).

86. See generally 7C J.W. Hicks, *supra* note 26, Chs. 11 & 15, respectively.

87. Release No. 5223, *supra* note 85, at 81,056-81,057; Release No. 5121, *supra* note 23, at 80,097.

88. 15 U.S.C. § 77c(b) (1981).

89. 17 C.F.R. § 230.504(b)(1) (1987) incorporates 17 C.F.R. §§ 230.502(c) and (d).

90. 17 C.F.R. § 230.505(b)(1) (1987) incorporates 17 C.F.R. § 230.502(d) (1987).

91. 15 U.S.C. § 77c(a)(11) (1981).

92. SEC Securities Act Release No. 4708 (July 9, 1964), Fed. Sec. L. Rep. (CCH) ¶ 1361 [hereinafter Release No. 4708].

93. Release No. 4434, *supra* note 64, ¶ 2275 at 2610.

residents is permitted,⁹⁴ it is the issuer's burden to prove that no reoffers or resales to nonresidents take place until the entire issue comes to rest, a process that the SEC has suggested could take a full year.⁹⁵ As a practical matter, many issuers curtail any trading within one year from the last sale by the issuer.⁹⁶ The ban on sales to out-of-state persons is deemed necessary in order for the transaction to retain the local character that Congress intended it to have.⁹⁷ Foreign offerings present a similar problem for the issuer.

In Release No. 4708 the SEC stated that it would not take any enforcement action against a domestic issuer for failure to register its securities being offered and sold abroad exclusively to foreign investors in a manner which would result in the securities coming to rest abroad.⁹⁸ In order to guarantee that unregistered securities sold to foreign investors do not prematurely flow back into this country, the issuer is expected to impose restrictions on the subsequent transfer of those securities.⁹⁹ Relying on informal SEC staff guidelines,¹⁰⁰ issuers prohibit for a period of ninety days, measured from the end of the foreign offering, either transfers to any person,

94. *Id.*

95. Goldman, *The Intrastate Offering*, in *NEW TRENDS AND SPECIAL PROBLEMS UNDER THE SECURITIES LAW* 173, 182 (A. Sommer ed. 1970). Mr. Goldman was at the time an Associate Regional Administrator for the SEC. This one-year measure of safety is also consistent with the one-year statute of limitation period in § 13 for instituting suits under the civil liability provisions of § 12. 15 U.S.C. § 77m(1) (1981).

The one-year period was first suggested by the Commission in *Brooklyn Manhattan Transit Corp.*, 1 S.E.C. 147, 163 (1935). *See infra* text accompanying note 263. In responding to requests for no-action letters, premised on § 3(a)(11), the SEC has usually refused to express any view on whether securities have come to rest. *See, e.g.*, Valient Steel & Equip., Inc., No-action letter from SEC (July 2, 1976), [1971-76] Wash. Serv. Bur. Microfiche, fiche 267, frame C6; Hynes & Howes Mortgage Co., No-action letter from SEC (Dec. 1, 1972), [1971-76] Wash. Serv. Bur. Microfiche, fiche 258, frame C10.

Under the safe harbor rule for § 3(a)(11) interstate trading may commence nine months after the last sale by the issuer. 17 C.F.R. § 230.147(e) (1987). *See infra* text accompanying note 96.

96. The Commission addressed the problems inherent in intrastate trading that follow § 3(a)(11) issues in response to a practice used by broker-dealers in Minnesota in 1961. Securities Act Release No. 4386, [1957-61 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,774 (July 12, 1961). According to the release, underwriters and participating dealers were soliciting "indications of interest," which the SEC believed amounted to orders, from residents of the state during the pendency of the registration application filed with state authorities. In most cases, the intrastate offerings were completely sold on the date when the registration with the state became effective. Shortly thereafter, trading was commenced in the over-the-counter market. Many original purchasers sold at, or shortly thereafter, the commencement of trading and some of the stock was acquired by nonresidents. *Id.* at 80,905. The Commission concluded that:

the quick commencement of trading and prompt resale of portions of the issue to non-residents raises a serious question whether all of the issue has, in fact, come to rest in the hands of investors resident in the state of initial offering. Where these practices are followed, it is likely that portions of the issue will be offered or sold to non-residents through residents and dealers purchasing for resale and thus constitute elements of the distribution to investors. If so, in view of the considerations outlined above, exemption under Section 3(a)(11) is not available and the entire issue will have been offered and sold in violation of the Securities Act. Such an illegal distribution may not only subject the participants to enforcement action by the Commission, but subject them also to civil liability for damages or rescission under Section 12 of the Securities Act of 1933. *Id.* at 80,906.

97. Release No. 4434, *supra* note 64, at 2610.

98. Release No. 4708, *supra* note 92, ¶ 1362, at 2124. The Commission based this position on the definition of interstate commerce in § 2(7) of the Act, 15 U.S.C. § 77b(7) (1981). The release was in response to a Report of the President of the United States from the Task Force on Promoting Increased Foreign Investment in the United States Corporate Securities and Increased Foreign Financing for United States Corporations Operating Abroad (1964).

99. The Commission warned that the foreign offering "be effected in a manner which will result in the securities coming to rest abroad." Release No. 4708, *supra* note 92, ¶ 1362, at 2124.

100. *See, e.g.*, Fairchild Camera & Instrument Int'l Finance N.V., No-action letter from SEC (Nov. 15, 1976), [1971-76] Wash. Serv. Bur. Microfiche, fiche 661, frame D9; Raymond Int'l Inc., No-action letter from SEC (May 28, 1976), [1971-76] Wash. Serv. Bur. Microfiche, fiche 659, frame B8; The Singer Co. Int'l, No-action letter from SEC (August 2, 1974), [1971-76] Wash. Serv. Bur. Microfiche, fiche 646, frame A1.

foreign or domestic, or, in some cases, transfers in the United States or to U.S. persons.¹⁰¹ In the Commission's opinion the registration requirements of the Act were designed to assist American investors.¹⁰² Transfer restrictions on securities sold abroad are necessary to ensure that the issuer's transaction does not include "distribution or redistribution of the securities within, or to nationals of, the United States."¹⁰³ Where the issuer's transaction is restricted to foreign investors, the Commission believes that no policy of the Act is compromised by relieving the issuer of the burdens of registration.¹⁰⁴

b. Non-Issuer Transferor as Source of Limitations

Up to this point in the discussion of acquiring transactions the focus has been on the issuer as seller. An affiliate or a nonaffiliate of an issuer can also impose resale limitations as part of his transaction with another person.

Where an affiliate or a nonaffiliate acquires securities from an issuer in a nonpublic offering, he holds securities that are restricted within the meaning of rule 144(a)(3).¹⁰⁵ To avoid becoming a statutory underwriter when he transfers those securities, the affiliate or nonaffiliate holder can resell under rule 144.¹⁰⁶ Alternatively, the restricted holder can transfer the restricted securities privately and require of his transferee certain commitments as to when and how those securities are to be resold or transferred.¹⁰⁷ Where the private transfer takes the form of a sale the affiliate or nonaffiliate might claim the protection of the section 4(1-1/2) exemption.¹⁰⁸

Whether or not the transfer is a sale, the transferor might inform the transferee and the issuer that the securities will retain their restricted status, require the transferee to notify the transferor prior to retransfer, or secure the transferor's permission before attempting a retransfer. All of these limitations on resale appear to have their origin in the transferring transaction because the affiliate or nonaffiliate

101. See, e.g., Evans, *Offerings of Securities Solely to Foreign Investors*, 40 BUS. LAW. 69, 70-76 (1984); Tomlinson, *Federal Regulation of Secondary Trading in Foreign Securities*, 32 BUS. LAW. 463, 472-78 (1977).

102. Release No. 4708, *supra* note 92, ¶ 1362, at 2124.

103. *Id.* Where there is no danger of redistribution of securities within the United States, the SEC staff has permitted immediate trading. See, e.g., College Retirement Equities Fund, No-Action Letter from SEC (Feb. 18, 1987), [1987 Transfer Binder] (CCH) ¶ 78,420.

104. *Id.* An entirely separate issue, not the subject of Release No. 4708, is the extent to which the anti-fraud provisions of the 1933 and 1934 Acts apply extraterritorially. See generally Michaels, *Subject Matter Jurisdiction over Transnational Securities Fraud*, 71 CORNELL L. REV. 919 (1986); R. JENNINGS & H. MARSH, *supra* note 64, at 1592-1603.

105. 17 C.F.R. § 230.144(a)(3) (1987).

106. 17 C.F.R. § 230.144(b) (1987).

107. Because the Commission is concerned that transfers without consideration might become part of a wider distribution, it regulates resales by recipients under rule 144. See, e.g., Release No. 5223, *supra* note 85, at 81,058, where the SEC explained the effect of 17 C.F.R. § 230.144(e) (1987):

Amounts sold by a donee or trust, during any period of six months within two years after the acquisition of the securities by the donee or trust, shall be aggregated with those sold by the donor or settlor. Amounts of securities sold for the account of a pledgee or purchaser of pledged securities during any period of six months within two years after a default in the obligation secured by the pledge, shall be aggregated with the amount of securities sold by the pledgor. Since the donee, trust and pledgee stands in the "shoes" of the donor, settlor, and pledgor, the former persons are subject to the latter persons' limitations under the rule. The purpose of limited aggregation is consistent with the objectives of the Act, for otherwise a distribution or redistribution may be effectuated by such means as gifts, pledges, and trusts.

108. For a description of this so-called exemption, see *infra* text accompanying notes 137-41.

holder exercises individual control over the terms and conditions of the resale restrictions. However, none of these resale limitations would be needed if the affiliate or nonaffiliate holder were transferring unrestricted securities. It is because the issuer sought to protect the exemptive quality of its transaction with the affiliate or nonaffiliate holder that it restricted the transferability of the holder's securities. By placing limitations on his transferee, the affiliate or nonaffiliate transferor is discharging his responsibility to the issuer to make sure that his transfer will not destroy the exemption for the original transaction.

A nonaffiliate holding unrestricted securities has no difficulty claiming an exemption under section 4(1) and, therefore, is under no obligation to limit his transferee's resale rights.¹⁰⁹ However, for reasons discussed in connection with transferring transactions,¹¹⁰ an affiliate planning to resell unrestricted securities pursuant to the section 4(1-1/2) exemption, is required to limit his purchaser's resales.¹¹¹ Here, unlike transfers of restricted securities, the resale limitation cannot be traced back to an earlier transaction. The affiliate transferor is the only source for the holding period that his transferee must satisfy.¹¹²

c. SEC Policy as Source of Limitations

Not all resale limitations that emerge from acquiring transactions are the result of statutory or regulatory obligations imposed on the issuer or other transferor. Administrative interpretations by the SEC and its staff, that are designed to further the goals of the 1933 Act, account for many of the limitations on resale that securityholders, as transferees, encounter.

The best known among the staff-created restrictions are found in rule 144. It was designed to assist holders of restricted securities, whether affiliates or nonaffiliates, to resell publicly in reliance upon the section 4(1) trading exemption.¹¹³ In the course of clarifying when a transferee satisfies a holding period requirement that his transferor has imposed in the original transaction,¹¹⁴ the rule establishes several additional limitations. In order to enjoy the benefits that rule 144 provides against the possibility of a holder's resales being deemed a distribution and, therefore, of his status changing to that of an underwriter, a prospective seller of restricted securities

109. See *supra* text accompanying notes 56-59.

110. See *infra* text accompanying notes 142-46.

111. See *supra* text accompanying notes 51-55.

112. See *infra* text accompanying note 146.

113. Release No. 5223, *supra* note 85, at 81,053-81,055. The rule was also designed to assist affiliates reselling unrestricted securities. See *infra* text accompanying notes 242-43. Rule 144(j), which was added to the rule by a 1979 amendment, makes clear that the rule is nonexclusive. SEC Securities Act Release No. 6032 [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,992 at 81,500 (March 5, 1979). See generally 7B J.W. HICKS, *supra* note 26, § 10.14. Despite the presence of rule 144(j), many attorneys believe that the following statement, which was made by the Commission at the time of the rule's adoption, continues to reflect enforcement policy:

[P]ersons who offer or sell restricted securities without complying with rule 144 are hereby put on notice by the Commission that in view of the broad remedial purposes of the Act and of public policy which strongly supports registration, they will have a substantial burden of proof in establishing that an exemption from registration is available for such offers or sales and that such persons and the brokers and other persons who participate in the transactions do so at their risk.

Release No. 5223, *supra* note 85, at 81,050.

114. 17 C.F.R. § 230.144(d) (1987).

must be sure that all of these conditions are met: (i) the availability of adequate current information about the issuer;¹¹⁵ (ii) a limited volume of resales during a three-month period;¹¹⁶ (iii) the use of brokerage transactions without any solicitation by the holder of offers to buy and without any payment of extra commissions;¹¹⁷ and (iv) a notice of sale to the Commission.¹¹⁸ The Commission stated at the time it adopted rule 144 that these additional limitations on public resales of restricted securities were needed because experience had demonstrated that the traditional holding period requirement "has not assured adequate protection of investors through the maintenance of informed trading markets and has led to uncertainty in the application of the registration provisions of the Act."¹¹⁹ Nonetheless, the rule, as amended, grants to nonaffiliate holders of restricted securities a dispensation from all of these additional requirements provided the securities have been beneficially owned by the person for a period of at least three years prior to their sale.¹²⁰

The Commission has extended rule 144-type limitations to recipients who would otherwise not be prohibited from reselling publicly. In each instance, the circumstances surrounding the acquiring transaction are thought to justify the limitations.

i. No-Sale Transfers

The registration requirements are premised on an offer to sell a security. Where an issuer's securities transaction does not involve a sale it avoids registration and the limitations associated with transactional exemptions.¹²¹ The same analysis holds true for an affiliate's transaction. Faced with the prospect of large quantities of securities flowing into the secondary markets without the type of disclosure that registration would provide, the SEC has determined that the securities in certain non-sale transactions might be deemed restricted in the hands of the original transferees. This administrative policy could affect such recipients as an employee holding bonus or gift securities from the issuer,¹²² a pledgee of securities acquired from an affiliate

115. 17 C.F.R. § 230.144(e) (1987).

116. 17 C.F.R. § 230.144(e) (1987). The volume standards in rule 144(e)(1) have been liberalized in a series of amendments to the rule. *See generally* 7B J.W. Hicks, *supra* note 26, § 10.09[4][d].

117. 17 C.F.R. § 230.144(f) & (g) (1987).

118. 17 C.F.R. § 230.144(h) (1987). The person filing a notice under rule 144(h) must have "a bona fide intention to sell the securities referred to therein within a reasonable time after the filing of such notice." 17 C.F.R. § 230.144(i) (1987).

119. Release No. 5223, *supra* note 85, at 81,053.

120. 17 C.F.R. § 230.144(k) (1987). A 1983 amendment to rule 144 eliminated the requirement under rule 144(k) that current information be publicly available with respect to an issuer of restricted securities. SEC Securities Act Release No. 6488 [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,429 (Sept. 23, 1983).

121. The registration requirements of § 5 are dependent upon an "offer" or "sale," 15 U.S.C. § 77e (1981), and those terms require that an attempted disposition be "for value." 15 U.S.C. § 77b(3) (1981).

122. *See, e.g.*, Dow Corning Corp., No-action letter from SEC (Aug. 23, 1976), [1971-76] Wash. Serv. Bur. Microfiche, fiche 64 frame A12; Wetterau, Inc., No-action letter from SEC (Dec. 30, 1974), [1971-76] Wash. Serv. Bur. Microfiche, fiche 144 frame C9. Where an issuer's securities are distributed to employees as part of an employee benefit or award plan, the status of the securities under rule 144(a)(3) depends on several factors. *See* 7B J.W. Hicks, *supra* note 26, §§ 10.05[3][b] & [j].

pledgor,¹²³ a trust or estate acquiring securities from an affiliate settlor or decedent,¹²⁴ and recipients of securities spun off as a dividend in kind.¹²⁵

ii. *Presumptive Underwriters*

Purchasers of large blocks of securities that are sold in registered primary or secondary offerings might be subject to the disabilities of a statutory underwriter. Under the so-called presumptive underwriter doctrine,¹²⁶ the SEC staff evaluates these purchasers in terms of such other factors as: (i) the total number of securities being sold, (ii) the number of securities being sold in relationship to the total amount of securities not subject to trading restrictions (sometimes called the "float"), (iii) the trading volume of that class of securities, and (iv) the nature of the issuer.¹²⁷ Depending upon which factors it uses, the SEC staff will presume that these nonaffiliates, who are frequently life insurance companies and other institutional investors, are underwriters unless they resell in accordance with the volume limitations of rule 144.¹²⁸ Although this doctrine is triggered by the amount of securities purchased in the acquiring transaction, it is usually justified in terms of the impact that an unregulated transferring transaction of this magnitude would otherwise have on ordinary trading patterns in the secondary market.¹²⁹ The presumptive underwriter doctrine and analogous administrative attempts to control resales of unrestricted securities¹³⁰ can also be seen as products of a broader policy that in administering and implementing the

123. See, e.g., Mary Moppet's Day Care Schools, No-action letter from SEC (Oct. 31, 1977), [1977] (CCH) Fed. Sec. Microfiche, fiche 73, frame F5; See 7B J.W. Hicks, *supra* note 26, § 10.05[3][c].

124. See, e.g., Pneumatic Scale Corp., No-action letter from SEC (Jan. 29, 1975), [1971-76] Wash. Serv. Bur. Microfiche, fiche 46, frame B2, [trust beneficiary]; Inland Steel Co., No-action letter from SEC [1974-75 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 80,086 (Dec. 3, 1974) [estate beneficiary]. See 7B J.W. Hicks, *id.*, § 10.05[3][d].

125. See, e.g., Standard Resources, Inc., No-action letter from SEC (March 12, 1976), [1971-76] Wash. Serv. Bur. Microfiche, fiche 657, frame F8. More recent staff interpretations of rule 144(a)(3) are nonliteralist and depend on the application of several criteria. See 7B J.W. Hicks, *supra* note 26, § 10.05[3][k].

126. See generally Nathan, *Presumptive Underwriters*, 8 REV. SEC. REG. 881 (1975); M. STEINBERG, SECURITIES REGULATION 273-74 (1986).

127. See 7B J.W. Hicks, *supra* note 26, § 9.02[5][b]; D. GOLDWASSER, A GUIDE TO RULE 144, 424-29 (1978); Nathan, *The SEC's Presumptive Underwriter Doctrine*, 7 PLI INST. SEC. REG. 269, 282 (R. Mundheim, A. Fleischer & Vandergrift eds. 1976).

128. See, e.g., Comten, Inc., No-action letter from SEC (March 23, 1976), [1971-76] Wash. Serv. Bur. Microfiche, fiche 588, frame B2; Docutel Corp., No-action letter from SEC (Dec. 6, 1976), [1971-76] Wash. Serv. Bur. Microfiche, fiche 169, frame C8. A staff interpretative response to American Council of Life Ins., No-action letter from SEC [1983-84 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 77,526 (May 10, 1983), indicates a partial retreat from the presumptive underwriter doctrine.

129. See, e.g., Nathan, *supra* note 127, at 280 (remarks by Alan Levenson, Director of the SEC Division of Corporation Finance); *id.* at 299.

130. See, e.g., (1) 17 C.F.R. § 230.148 (1987) holders who resell securities issued or sold in connection with bankruptcy proceedings; J.W. Hicks, *supra* note 26, § 3.06[6][b]; (2) owners subject to the so-called underwriter or finder compensation rule, discussed in SEC Release No. 6099 (Aug. 2, 1979) 1 Fed. Sec. L. Rep. (CCH) ¶ 2705H, at 2819-7 item (10) & note 8. See 7B J.W. Hicks, *supra* note 26, § 10.05[3][f]; (3) recipients of more than one percent of shares issued in certain § 3(a)(10) transactions. See, e.g., Citizens First Bancshares, Inc., No-action letter from SEC (June 17, 1985), [1985] Wash. Serv. Bur. Microfiche, fiche 932, frame B1; Bank of Highland, No-action letter from SEC (Sept. 6, 1984), [1984] Wash. Serv. Bur. Microfiche, fiche 814, frame B10; Int'l H.R.S. Industries, Inc., No-action letter from SEC (March 15, 1984), [1984] Wash. Serv. Bur. Microfiche, fiche 759, frame C4. See 7B J.W. Hicks, *supra* note 26, § 3.06[5]; (4) distributees from an employee stock ownership plan. See, e.g., TNP Enters., Inc., No-action letter from SEC (Oct. 20, 1987), [1987] Wash. Serv. Bur. Microfiche, fiche 1302, frame C9.

federal securities laws, the Commission should "coordinate and integrate the disclosure system with the exemptive provisions provided by the laws."¹³¹

iii. Rule 145(a) Transactions

The Commission has developed special resale controls for recipients of registered securities sold in a transaction covered by rule 145(a)¹³²—a reclassification, merger or consolidation, and transfer of assets—and, by analogy, for recipients of unregistered securities in any of these transactions that is exempted because of the availability of either the section 3(a)(9) or 3(a)(10) exemption or the Regulation A exemption.¹³³ In all three types of transactions, the seller is not required to restrict the transferability of the securities it delivers in connection with a plan or agreement. The Commission has determined, however, that any person who is an affiliate of the company whose assets or capital structure are affected by any of these transactions,

131. SEC Securities Act Release No. 5450 [1973-74 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,617 at 83,649 (Jan. 7, 1974) [adoption of rule 147]. The Commission has relied upon this same policy objective in the adoption of rule 144 Release No. 5223, *supra* note 85; in the adoption of rule 145, SEC Securities Act Release No. 5316 [1972-73 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 79,015 (Oct. 6, 1972); and in its announcement of proposed rule 146, SEC Securities Act Release No. 5336 [1972-73 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,108 (Nov. 28, 1973).

132. 17 C.F.R. § 230.145(a) (1987):

(a) *Transactions Within the Rule.* An "offer," "offer to sell," "offer for sale" or "sale" shall be deemed to be involved, within the meaning of Section 2(3) of the Act, so far as the security holders of a corporation or other person are concerned where, pursuant to statutory provisions of the jurisdiction under which such corporation or other person is organized, or pursuant to provisions contained in its certificate of incorporation or similar controlling instruments, or otherwise, there is submitted for the vote or consent of such security holders a plan or agreement for—

(1) *Reclassifications.* A reclassification of securities of such corporation or other person, other than a stock split, reverse stock split, or change in par value, which involves the substitution of a security for another security;

(2) *Mergers or Consolidations.* A statutory merger or consolidation or similar plan or acquisition in which securities of such corporation or other person held by such security holders will become or be exchanged for securities of any other person, unless the sole purpose of the transaction is to change an issuer's domicile solely within the United States; or

(3) *Transfers of Assets.* A transfer of assets of such corporation or other person, to another person in consideration of the issuance of securities of such other person or any of its affiliates, if:

(A) such plan or agreement provides for dissolution of the corporation or other person whose security holders are voting or consenting; or

(B) such plan or agreement provides for a pro rata or similar distribution of such securities to the security holders voting or consenting; or

(C) the board of directors or similar representatives of such corporation or other person, adopts resolutions relative to (A) or (B) above within one year after the taking of such vote or consent; or

(D) the transfer of assets is a part of a pre-existing plan for distribution of such securities, notwithstanding (A), (B) or (C), above.

Securities issued in transactions described in rule 145(a) may be registered or the transactions might qualify for an exemption under §§ 3(a)(9), 3(10), (11), and 4(2). Preliminary Note to the Rule. *Id.* The resale limitations are found in 17 C.F.R. § 230.145(c) and (d) (1987), discussed *infra* notes 134 and 136.

133. SEC Securities Act Release No. 6099 (Aug. 2, 1979) Fed. Sec. L. Rep. (CCH) ¶ 2705H, at 2819-27 item (87). See also Borland Int'l, Inc., No-action letter from SEC (Sept. 28, 1987), [1987] Wash. Serv. Bur. Microfiche, fiche 1295, frame B5 [merger effected pursuant to § 3(a)(10)]; St. Ives Holding Co., No-action letter from SEC (July 22, 1987), [1987 Transfer Binder] Federal Securities Law Report (CCH) ¶ 78,465 [merger reorganization pursuant to § 3(a)(10)]; Commerce Am. Corp., No-action letter from SEC (Nov. 15, 1985), [1985] Wash. Serv. Bur. Microfiche, fiche 979, frame B14 [merger pursuant to § 3(a)(10)]; Clevepak Corp., No-action letter from SEC (Feb. 23, 1984), [1984] Wash. Serv. Bur. Microfiche, fiche 745, frame B14 [exchange, following merger, pursuant to § 3(a)(9)]. In these situations the staff advises that persons who are described in rule 145(c) should resell the unregistered securities received in the transaction in the manner permitted by rule 145(d)(1) without regard to the holding period required by rule 144(d)(1). See generally Ash, *Reorganizations and Other Exchanges Under Section 3(a)(10) of the Securities Act of 1933*, 75 Nw. U.L. Rev. 1 (1980).

other than the issuer, should not be able to freely resell the securities of the issuer acquired in connection with the transaction.¹³⁴ According to the SEC, any person who controls the company that will be affected by the transaction is presumably in a position to influence the terms of the transaction.¹³⁵ In the Commission's view, this person resembles a private purchaser in a negotiated sale by the issuer and, therefore, if he publicly offers or sells securities acquired in connection with the transaction he will be deemed an underwriter within the meaning of section 2(11). Relief from this prohibition on public resales is provided by rule 145(d) but only if the securityholder resells pursuant to rule 144 or retains beneficial ownership of the securities for a period of three years.¹³⁶

iv. *Private Resales*

A securityholder who resells restricted securities privately can avoid underwriter status by meeting the conditions of the section 4(1-1/2) exemption.¹³⁷ One of those conditions, discussed above in connection with limitations imposed by the issuer or affiliate,¹³⁸ is that the private purchaser also be subject to a holding period requirement. The SEC and some commentators believe that the affiliate or nonaffiliate claiming section 4(1-1/2) must do more.¹³⁹ The Commission has characterized the exemption as a "hybrid" which applies only where "some of the established criteria for sales under both Section 4(1) and Section 4(2) of the Act are satisfied."¹⁴⁰ Neither the Commission nor the staff has identified which of the traditional criteria of a valid section 4(2) offering by an issuer are to become part of a valid section

134. 17 C.F.R. § 230.145(c) (1987):

(c) *Persons and Parties Deemed to be Underwriters.* For purposes of this rule, any party to any transaction specified in paragraph (a), other than the issuer, or any person who is an affiliate of such party at the time of any such transaction is submitted for vote or consent, who publicly offers or sells securities of the issuer acquired in connection with any such transaction, shall be deemed to be engaged in a distribution and therefore to be an underwriter thereof within the meaning of Section 2(11) of the Act. The term "party" as used in this paragraph (c) shall mean the corporations, business entities, or other persons, other than the issuer, whose assets or capital structure are affected by the transactions specified in paragraph (a).

Rule 145(e) defines the term "person" for purposes of paragraphs (c) and (d) as having the same meaning as the definition of that term in 17 C.F.R. § 230.144(a)(2). 17 C.F.R. § 230.145(e) (1987).

135. For a detailed discussion of rule 145, see *infra* text accompanying notes 215-36.

136. 17 C.F.R. § 230.145(d) (1987):

(d) *Resale Provisions for Persons and Parties Deemed Underwriters.* Notwithstanding the provisions of paragraph (c), a person or party specified therein shall not be deemed to be engaged in a distribution and therefore not be an underwriter of registered securities acquired in a transaction specified in paragraph (a) of this section if: (1) such securities are sold by such person or party in accordance with the provisions of paragraphs (c), (e), (f) and (g) of § 230.144; (2) such person or party is not an affiliate of the issuer and has been the beneficial owner of the securities for at least two years as determined in accordance with paragraph (d) of § 230.144, and the issuer meets the requirements of paragraph (c) of § 230.144; or (3) such person or party is not, and has not been for at least three months, an affiliate of the issuer and has been the beneficial owner of the securities for at least three years as determined in accordance with paragraph (d) of § 230.144.

See SEC Securities Act Release No. 6508 (Feb. 10, 1984), [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,489; 7B J.W. Hicks, *supra* note 26, § 9.04[1][b].

137. Technically the so-called § 4(1-1/2) exemption is based on § 4(1). See the detailed discussion *infra* text accompanying notes 253-56.

138. See *supra* text accompanying note 105.

139. See *infra* note 141.

140. Securities Act Release No. 6188, 1 Fed. Sec. L. Rep. (CCH) ¶ 1051 at 2073-28 n.178, 2073-28 & 2073-29 (Feb. 1, 1980).

4(1-1/2) exemption. It has been suggested, however, that the staff contemplates a private sale with a limited number of sophisticated buyers accompanied by disclosure of registration statement information and without general solicitation or advertising.¹⁴¹

2. Transferring Transactions

The possibility exists for certain persons who hold securities issued by another person that the act of transferring those securities will require them to impose resale limitations on themselves or on their transferee. This potential danger awaits affiliates but not nonaffiliates. As discussed earlier,¹⁴² the only impediment to freely tradeable securities by a nonaffiliate are restrictions that flow out of the acquiring transaction. An affiliate can encounter the same limitations in his acquiring transaction but he may also have to create or experience them in order to rely upon the section 4(1) trading exemption.

An affiliate's acquiring transaction can be free of resale limitations for many reasons. For instance he might have purchased securities in a registered offering or in ordinary secondary acquisitions with the assistance of his broker. He might have bought unrestricted securities in private transactions or received them as a gift from a nonaffiliate donor. Where an affiliate securityholder decides to resell unrestricted securities without the benefit of a registration statement he must consider the possibility that the volume of his resale transaction will reach such significant proportions that it will be deemed a distribution. In the event of a distribution attributable to him, the affiliate will be denied an exemption under section 4(1).¹⁴³ To guard against these occurrences the affiliate might decide to structure his resales so that the transaction meets the conditions of rule 144 or that satisfies the informal requirements of so-called section 4(1-1/2).¹⁴⁴ If the affiliate chooses the first option, which is available only where the issuer has satisfied the current public information requirements of rule 144(c), he must sell his securities in brokers' transactions and in an amount limited by rule 144(e)(1). Securities sold in this fashion are unrestricted in the hands of the purchaser.¹⁴⁵ Alternatively, the affiliate can sell his securities in privately negotiated transactions where he must impose resale restrictions on his buyer and, depending upon the conditions of a section 4(1-1/2) exemption, suffer additional burdens himself.¹⁴⁶

141. Olander & Jacks, *The Section 4(1-1/2) Exemption—Reading Between the Lines of the Securities Act of 1933*, 15 SEC. REG. L.J. 339, 362-63 (1988); see Comment, *Reinterpreting the "Section 4(1-1/2)" Exemption from Securities Registration: The Investor Protection Requirement*, 16 U.S.F.L. REV. 681 (1982).

142. See *supra* text accompanying notes 109-12.

143. See *supra* text accompanying notes 45-55.

144. See *supra* text accompanying notes 137-41.

145. Because sales pursuant to rule 144 are public in character the securities do not fall within the definition of restricted securities. 17 C.F.R. § 230.144(a)(3) (1987). See, e.g., Kidder, Peabody & Co., SEC No-Action Letter (Nov. 12, 1976), [1971-76] Wash. Serv. Bur. Microfiche, fiche 69, frame A14.

146. See *supra* text accompanying notes 137-41. The securities that an affiliate sells privately in reliance on § 4(1-1/2) are deemed to be restricted within the meaning of rule 144(a)(3). See, e.g., Candela Laser Corp., SEC No-Action Letter [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,530 at 77,729 (Sept. 28, 1987).

III. ANALYTICAL PROBLEMS

Misconceptions about what constitutes a transaction or about the purpose that resale limitations serve as part of a transaction can take many forms. In this part of the Article, I examine three situations in which resale limitation policy was determined without proper regard for the analysis that Congress intended: (i) the coming to rest doctrine under section 3(a)(11) as interpreted in *Busch v. Carpenter*;¹⁴⁷ (ii) the *Ralston Purina* standards¹⁴⁸ as applied to private resales, according to *Gilligan, Will & Co. v. SEC*;¹⁴⁹ and (iii) the underwriter status of affiliates in companies acquired by an issuer in a registered offering, as formulated in rule 145(c).¹⁵⁰ These three illustrations are useful for several reasons. First, they represent a wide range of decisionmakers and advocates who regularly help shape resale limitation policy. Included among those who contributed to these debates are private litigants, district and appellate courts, and the SEC in the roles of amicus curiae, reviewer of a hearing officer's decision, appellee before an appellate court, and policymaker in the adoption of an interpretive rule. Second, the decisions selected for review offer some evidence of objectivity. They demonstrate that erroneous analysis can occur in an attempt to liberalize resale limitations, as in *Busch v. Carpenter*, or to enforce them, as in *Gilligan, Will & Co.* and in Rule 145(c). Third, a variety of settings is captured within this small sample. The issue of resale policy surfaces in connection with both registered and unregistered public offerings (rule 145(c) and *Busch* respectively) and with a nonpublic offering (*Gilligan, Will*). Finally, these illustrations are a good introduction to the many forms that mistaken analysis can take: (i) reducing resale limitations by redefining an issuer's burden of proof (*Busch*); (ii) incorporating resale restrictions of one exemption into a dissimilar exemption (*Busch* and *Gilligan, Will*); (iii) equating restrictions from an acquiring transaction with those from a transferring transaction (*Gilligan, Will* and rule 145(c)); and (iv) retaining resale limitations for a transaction that undergoes total regulatory revision (rule 145(c)).

A. *The Coming to Rest Doctrine Under Section 3(a)(11)*

In order for an intrastate offering to qualify under section 3(a)(11) the issuer must prove that the issue has come to rest in the hands of persons who have the same residence as the issuer.¹⁵¹ The transactional nature of the exemption requires that an issuer's characterization of an offering as local be evaluated on more than the residence of the original purchasers even where the issuer has no intention of using original purchasers as the first step in an interstate distribution. The recommended method for meeting this condition is for the issuer to restrict resales to residents for

147. 598 F. Supp. 519 (D. Utah 1984), *aff'd in part, rev'd in part*, 827 F.2d 653 (10th Cir. 1987).

148. *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).

149. 267 F.2d 461 (2d Cir. 1959), *cert. denied*, 361 U.S. 896 (1959).

150. 17 C.F.R. § 230.145(c) (1987). *See supra* note 134 for full text.

151. Applicability of Exemption of Intrastate Offerings, Securities Act Release No. 1459, 1 Fed. Sec. L. Rep. (CCH) ¶ 2260, at 2605-606 (May 29, 1937); Release No. 4434, *supra* note 64, at 2610.

a period of at least nine months from the date of the issuer's last sale.¹⁵² In *Busch v. Carpenter*, the Tenth Circuit rejected this traditional theory for the coming to rest requirement.¹⁵³

In October 1980, Carpenter and two other defendants organized Sonic Petroleum, Inc. in Utah allegedly in order to acquire, extract, and market material resources such as oil, gas, and coal. During October and November 1980, Sonic publicly offered and sold 25,000,000 shares of its stock entirely to Utah residents. After deducting underwriting costs, Sonic realized net proceeds of \$435,000. Approximately six months after the last intrastate sale, William Mason, an Illinois oil and gas promoter, contacted defendant Carpenter in his capacity as president of Sonic, about a merger of Sonic with Mason's operations in Illinois. These discussions resulted in an agreement, effective May 25, 1981, under which Sonic issued a controlling interest in Sonic to Mason who, in return, transferred to Sonic an Illinois drilling corporation that Mason privately owned. The name of Sonic was changed to Mason Oil Co., Inc. and Carpenter, Jensen (another defendant), Mason, Mason's wife, and their son became officers and directors of the new company. Shortly thereafter, William Mason withdrew \$351,126 of the \$435,000 net proceeds of the Sonic intrastate offering and deposited them in Illinois. None of these withdrawn funds was used in Utah. Finally, in May 1981 Mason and Carpenter established Norbil Investments, a brokerage account in Utah, in order for Mason and his friends to purchase shares of the new company's stock. From December 1980 through June 18, 1981, the date when the plaintiffs, who were California residents, bought their stock through Norbil Investments, the shares of Sonic stock were being publicly traded in the over-the-counter market in Salt Lake City, Utah.¹⁵⁴

Plaintiffs sought rescission under section 12(1) against Carpenter and two other individuals who were associated with Sonic to recover the purchase price of 76,000 shares of Sonic stock. The complaint alleged that the Sonic securities had not been registered and did not qualify for the section 3(a)(11) exemption. Plaintiffs charged the individual defendants with liability either as sellers, for purposes of section 12(1), or as controlling persons under section 15 of the Act.¹⁵⁵

152. The nine-month ban on interstate trading comes from rule 147(e) and is applicable only when the issuer meets all of the terms and conditions of the rule. 17 C.F.R. § 230.147(e) (1987). See also *supra* text accompanying notes 94–97.

153. 827 F.2d 653 (10th Cir. 1987).

154. Between May and August, 1981, after Sonic's name had been changed to Mason Oil, approximately 893,000 shares of Mason Oil stock were purchased in the Norbil Investments account for eleven out-of-state purchasers, including plaintiffs. The shares were held in Norbil's name until late October, 1981 when Carpenter transferred the stock into the names of the actual purchasers. Brief of the SEC, *Amicus Curiae* [hereinafter SEC Brief] at 5–6. Although defendant Carpenter was not an investing member of Norbil Investments, he was one of its affiliates. Furthermore, the Tenth Circuit found that "Carpenter was a signatory on the Norbil account and bought stock for Mason and his friends in market transactions through Norbil." 827 F.2d 653, 659 (10th Cir. 1987).

155. 15 U.S.C. § 770 (1981):

Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under [section 11 or 12], shall also be liable jointly and severally with and to the same extent as such to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

The district court framed the issue for resolution as "whether a resale of an intrastate offering seven months after all shares were sold to Utah residents voids the intrastate exemption."¹⁵⁶ The court began its analysis by observing that the language of section 3(a)(11) does not make the exemption "dependent on not reselling the stock."¹⁵⁷ It then focused on the uncontested facts and the allegations in the complaint. It found that at the time the initial sale occurred the Sonic stock was sold only to Utah residents. It also found "no allegation of any fraud, scheme or other plan to circumvent the policies of the intrastate exemption through a straw person sale."¹⁵⁸ Without explicitly acknowledging the validity of the SEC's doctrine, the court used these two factors to conclude that the seven month period from the time of initial sale to the time of resale was sufficient for the offering to come to rest.¹⁵⁹ In response to plaintiffs' argument that Sonic had not complied with rule 147's nine-month ban on interstate trading the court had two comments. First, the rule is nonexclusive; noncompliance with the resale limitation in rule 147(e) does not mean that the statute and the underlying policies have been violated. Second, the rule is considered by some to be a more restrictive interpretation of section 3(a)(11) than Congress intended.¹⁶⁰ Because the court also determined that the issuer had been doing business in Utah,¹⁶¹ it denied plaintiffs' motion for summary judgment and, finding that defendants had complied with section 3(a)(11), granted defendants' motion for summary judgment and dismissed the complaint.

On appeal to the Tenth Circuit, plaintiffs, who were joined by the SEC as an amicus curiae, abandoned their claim that resale alone was enough to defeat the exemption. Instead they adopted the Commission's contention that because defendants had the burden to show their right to section 3(a)(11), they had the burden at the trial level to present evidence that the original purchasers of Sonic stock bought with investment intent. Without such a showing, the SEC argued, summary judgment for defendants was improper.¹⁶² The Tenth Circuit rejected the amicus' argument. It found unacceptable the notion that "the issuer should be required to disprove all the possible circumstances that might establish the stock has not come to rest."¹⁶³ In the appellate court's opinion it seemed more logical that the party opposing the motion should have the "burden of producing some contrary evidence on this issue when the seller claiming the exemption has satisfied the facial requirement of the statute."¹⁶⁴ Once an issuer proves that the stock was sold only to residents, it falls to the plaintiff "to produce evidence that the stock had not come to rest but had been sold to people

156. 598 F. Supp. 519 (D. Utah 1984), *aff'd in part, rev'd in part*, 827 F.2d 653 (10th Cir. 1987).

157. *Id.*

158. *Id.* at 520.

159. *Id.*

160. *Id.* The court cited as an example of the criticism of rule 147, Bennett, *The Proposed Federal Securities Code: "Local Distributions,"* UTAH B.J., Winter 1979, Summer 1980.

161. 598 F. Supp. 519, 520 (D. Utah 1984), *aff'd in part, rev'd in part*, 827 F.2d 653 (10th Cir. 1987). Both sides agreed that Sonic was a newly formed company, not yet operational, that maintained its offices, books and records in Salt Lake City. For a discussion of the doing business requirement of section 3(a)(11), see generally 7 J.W. Hicks, *supra* note 26, § 4.04[3].

162. 827 F.2d 653, 656 (10th Cir. 1987).

163. *Id.* at 657.

164. *Id.*

who intended to resell it out of state.”¹⁶⁵ In the face of defendants’ undisputed showing that all of the original buyers were residents and in the absence of any evidence to suggest that Sonic offered its shares under questionable circumstances, the Tenth Circuit affirmed the trial court’s ruling that the issue had come to rest.¹⁶⁶

The dispute over the coming to rest requirement at both the district and appellate court levels involved a direct attack on the transactional nature of section 3(a)(11). The essence of this challenge, as articulated in the bar journal article cited by the district court¹⁶⁷ and in the brief of appellee Carpenter,¹⁶⁸ was that Congress intended the existence of a section 3(a)(11) exemption to be determined at the time sales by the issuer were completed so that no undue restrictions would be placed on resales in the over-the-counter market. What the Tenth Circuit did in response to this unorthodox view of section 3(a)(11) can be explained by looking at two aspects of the SEC’s ineffectual defense of the coming to rest requirement.

The Commission as amicus mounted a powerful case for the transaction concept. It explained the theoretical connection between resale limitations and a completed in-state distribution and properly objected to the lower court’s characterization of resales that “void” an existing exemption.¹⁶⁹ However, a more basic part of defendants’ charge was left intact. In support of their position that only the original sales by the issuer must be made to in-state residents, defendants cited the following colloquy on the floor of Congress:

Mr. Dirksen: The gentlemen will remember that in the discussion when the bill was under consideration in the House I voiced some apprehension about small corporate entities whose securities might be unregistered, that they might be placed under undue restrictions with respect to the over-the-counter markets. I understand the bill has been amended and an exception has been made in their favor.

Mr. Rayburn: An exception is made in unregistered securities of companies predominately intrastate in nature.¹⁷⁰

165. *Id.*

166. *Id.* The Tenth Circuit did not accept the lower court’s conclusion that Sonic was doing business in Utah and, therefore, found that a genuine issue of material fact existed precluding summary judgment in favor of all defendants. *Id.* at 659. It determined that none of the defendants, except Carpenter, could qualify as a § 12(1) seller or a person in a control relationship with Sonic. Accordingly, summary judgment was held to be proper in favor of these defendants. *Id.* at 660. Because the record raised issues of fact regarding the extent of Carpenter’s participation in the sales, the court held that summary judgment on this issue was improper. *Id.*

167. Bennett, *supra* note 160, at 5. Mr. Bennett served as legal counsel for defendants-appellees Jensen and Burnett. 827 F.2d 653, 654 (10th Cir. 1987). A copy of his bar journal article was included as part of the record in the case. Brief of Appellee Craig Carpenter at 15 [hereinafter Carpenter Brief].

168. Carpenter Brief, *id.* at 7–9.

169. SEC Brief, *supra* note 154, at 9–13. The district court defined the legal issue that it faced, *supra* text accompanying note 156, as whether a resale “voids the intrastate exemption.” 598 F. Supp. 519 (D. Utah 1984), *aff’d in part, rev’d in part*, 827 F.2d 653 (10th Cir. 1987). As the SEC correctly stated in its supplemental brief: “[T]he exemption is not available until and unless the distribution is completed in-state. Thus, resales out-of-state that are part of the distribution do not void an existing exemption. Rather, the offering never did qualify for the exemption.” Supplemental Brief of the Securities & Exchange Commission, Amicus Curiae, at 7 [hereinafter SEC Supplemental Brief]. The Tenth Circuit granted appellees’ motion to strike the SEC supplemental brief, apparently on the ground that amici are not entitled to respond. For my purposes, however, the supplemental brief remains a valuable source of information on the SEC’s attitude towards the coming to rest doctrine.

170. 73 CONG. REC. 10,269 (1934).

According to defendants, this expression of congressional intent is inconsistent with an interpretation of section 3(a)(11) that requires the issuer to monitor each securityholder's resale for an undetermined period of time. Congress did not intend, they argued, that these burdens be placed on the issuer or on the secondary sales of securities from an intrastate offering.¹⁷¹ In fact the colloquy between Representatives Dirksen and Rayburn had nothing to do with section 3(a)(11). It occurred during consideration of the Conference Committee Report on House Bill 9323, in connection with the passage of the Securities Exchange Act of 1934, and was concerned with the possible impact that proposed margin requirements would have on brokerage customer loans that were collateralized with unlisted securities.¹⁷² But because the

171. Carpenter Brief, *supra* note 167, at 7 & 9. The defendants criticized the Commission's view, as expressed in Release No. 4434, *supra* note 64, that an issuer must take precautions against an intrastate offering becoming an interstate distribution through resales:

The problem with such an interpretation is that depending on whether or not and to what degree it is carried to its ultimate end, *i.e.*, the issuer has a duty to monitor each stockholder's resale for an unlimited period of time, a tremendous burden is placed on the issuer and also on the viability of the secondary or over-the-counter market. Such burdens were never intended by the Congress, and to the extent such an interpretation by the Securities and Exchange Commission purports to require the company, at the risk of losing its intrastate exemption, to monitor or control sales of stock in the secondary market, such an interpretation is contrary to the intent of Congress, as expressed by Mr. Dirksen in his comments to Congress on the Bill. 78 CONG. REC., *supra*.

Id. at 9. See also Bennett, *supra* note 160, at 4-5.

Bennett and defendants argued that the decision by Congress in 1934 to move the intrastate exemption from § 5(c) to a section of the statute entitled "Exempted Securities" reflected the change that Representative Rayburn referred to in his response to Mr. Dirksen. *Id.* Furthermore, Bennett contended that the objective of the repositioning of the intrastate exemption was to change it from an exemption of transactions to an exemption of securities. *Id.* at 5. Although the Tenth Circuit did not embrace this erroneous reading of the legislative history, a lower court in that circuit was persuaded. *Leiter v. Kuntz*, 655 F. Supp. 725, 729-30 n.10 (D. Utah 1987). For an accurate interpretation of the relocation of the intrastate exemption, see 1 L. LOSS, SECURITIES REGULATION 709 (2d ed. 1961).

172. The reference by Representative Dirksen in the quoted interchange, *supra* note 170, to an earlier discussion was to a statement that he had made on May 2, 1934, concerning certain provisions in H.R. 9323, including § 6 entitled "Margin Requirements." H.R. 1383, 73rd Cong., 2d Sess. to accompany H.R. 9323, April 27, 1934. Paragraph (c) of proposed § 6 would have made it unlawful for a member of a national securities exchange or a broker or dealer who did business through such a member to extend or maintain credit in violation of regulations set forth in paragraphs (a) and (b), or without collateral or on collateral other than an exempted security or a security registered upon a national securities exchange, except as permitted by special rule and regulations of the Federal Reserve Board. *Id.* at 19. Representative Dirksen addressed those comments to the implications of proposed § 6(c):

Paragraph (c) of the same section states that it shall be unlawful for a member of the exchange, or for a broker or dealer who transacts through a member, to arrange or extend credit to a customer on any registered security except in accordance with the prescribed rules and regulations. It excludes exempted securities, which include Government and State and municipal obligations. Now, subsection (2), when read in connection with the above context, makes it unlawful to extend or arrange customer credit without collateral, or on any collateral other than registered or exempted securities except as prescribed by the Federal Reserve Board; and the only discretionary power of the Board is to permit credits on other collateral for a limited time under specified conditions, or to permit it if such credit is not to be used for purchasing or carrying registered securities.

The language is rather involved, but as I interpret it, I see some rather dangerous implications. Taking out registered and exempted securities, there remain the unlisted securities. Bear in mind that there are only 788 securities registered on the New York exchange, perhaps 500 on the Chicago exchange, and in similar proportion on the other exchanges. Then what about the thousands of unlisted securities that corporations in your district and mine have issued? Apparently these securities cannot be used as collateral in brokerage transactions if the purpose is to carry or trade in listed securities. Apparently no credit can be extended by a member or by a broker or dealer operating through a member except in accordance with rules and regulations made by the Federal Reserve Board. What about the rights of the hundreds of investment houses who now operate as brokers and dealers under a code of fair practice? If they must be subject to the special rules and regulations of the Federal Reserve Board, you are placing in the hands of that Board a weapon by which then can ultimately exercise complete control over all unlisted corporate securities and ultimately concentrate security transactions in the hands of a few and, incidentally thereto, control and regiment all business in this country.

73 CONG. REC. 7960. As a result of House Report No. 1838, 73rd Cong, 2nd Sess. (Conference Report) to accompany H.R. 9323, May 31, 1934, the margin requirements were moved to § 7, with paragraph (c) excluding from the margin

defendants' misreading of legislative history was not contradicted, it strengthened their assertion that resales are not part of the issuer's transaction and that traditional resale limitations under section 3(a)(11) are too restrictive. The significance of these propositions is evident in both the district and appellate court opinions.¹⁷³

The second problem with the Commission's effort to justify resale restrictions was its contention that in order to qualify for the exemption an issuer must prove "that the original buyers bought with investment intent."¹⁷⁴ Although the appellate court endorsed this interpretation,¹⁷⁵ the view is inconsistent with the statutory scheme and with the Commission's own position in rule 147(e).

By requiring an intrastate issuer to prove the investment intent of the initial purchasers, the SEC as amicus transformed section 3(a)(11) into a version of section 4(2). Post-acquisition conduct by original buyers, according to the amicus brief, has the same relevance to intrastate offerings as it does to private placements.

Where, as in the present case, the securities are resold out of state within a relatively short period of time, that fact may cause "evidentiary light" on the question of whether those securities actually came to rest in the hands of in-state purchasers, and may suggest that the stock was not taken with investment intent.¹⁷⁶

Under this approach intrastate buyers who lack the requisite investment intent become potential statutory underwriters as persons who have purchased from the issuer with a view to resale.¹⁷⁷ A major weakness with this position is that neither the statute nor the legislative history supports a literal application of section 2(11) to every person who purchases securities from an issuer in a public offering even if he does acquire them with a view towards immediate resale. In nonpublic offerings under sections 4(2) and 4(6), a requirement of investment intent serves the purpose of the exemptions by restricting the transactions to persons who can fend for themselves.¹⁷⁸ A public offering exempted under section 3(a)(11) is based on an entirely different

regulations "an exempted security." *Id.* at 7. The term "exempted security," which appeared in § 7(c), was defined in § 3(a)(12) to include "such other securities (which may include, among others, unregistered securities, the market in which is predominantly intrastate) as the Commission [the SEC] may, by such rules and regulations" exempt from the operation of any of the provisions of the statute. *Id.* at 4. After the colloquy between Representatives Dirksen and Rayburn quoted in the text, *supra* note 170, the House agreed to the conference report. 78 CONG. REC. 10269.

173. The district court stated that the statute by its literal language does not make the exemption dependent on not reselling the stock. 598 F. Supp. 519 (D. Utah 1984), *aff'd in part, rev'd in part*, 827 F.2d 653 (10th Cir. 1987). It then added: "This Court previously dismissed an S.E.C. complaint that alleged that all stock was sold only to residents of Utah and a subsequent resale took place one month later. SEC v. Curtis Minerals, No. C-336-69 (Nov. 19, 1971 D. Utah)." 598 F. Supp. at 519-20. Mr. Bennett, who advanced the erroneous interpretation of the Dirksen-Rayburn colloquy, *supra* note 171, was listed as counsel to defendant Curtis Minerals.

174. 827 F.2d 653, 656 (10th Cir. 1987).

175. *See id.*

176. SEC Brief, *supra* note 154, at 11.

177. SEC Supplemental Brief, *supra* note 169, at 5. Referring to the legislative history of § 4(1), H.R. REP. NO. 85, 73d Cong., 1st Sess. 15 (1933), the Commission stated:

As this shows, Congress was concerned, when it enacted the Securities Act, with protecting persons who purchase securities from issuers, underwriters or dealers. In this regard, "underwriters" were defined to include "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security." Section 2(11), 15 U.S.C. 77b(11) (emphasis added). Thus, among the purchasers protected by the Act are persons who purchase in resale transactions from persons who themselves have purchased from the issuer with a view to resale.

Id.

178. *See* SEC v. Ralston Purina, Co., 346 U.S. 119 (1953), discussed *infra* text accompanying note 198.

rationale. As the amicus correctly expressed it, purchasers of securities in section 3(a)(11) offerings "are in-state residents, sales to whom can be adequately regulated by state authorities, and who can be expected to be familiar with the issuer and thus do not need the protection of federal registration."¹⁷⁹ These reasons for the exemption justify a limitation on resales but they do not require the safeguard of investment intent that serves different goals under section 4(2).

The Commission's own rules are at odds with the position advanced in *Busch*. Rule 144(a)(3), which defines restricted securities that must be taken with investment intent, does not include securities issued under section 3(a)(11).¹⁸⁰ More importantly, the safe harbor rule 147 does not require purchasers to invest. Paragraph (e) acknowledges that trading activity can commence contemporaneously with the issuer's distribution.¹⁸¹ The only warning to an issuer is to be certain that until nine months after its final sale "all resales of any part of the issue, by any person, shall be made only to persons resident within such state or territory."¹⁸² Under rule 147(e) the critical issue, then, is not whether original purchasers have taken for investment but rather whether they have taken without a view to resale or distribution to nonresidents.

The Tenth Circuit opinion in *Busch* has made it easier for an issuer to market securities in reliance on section 3(a)(11). Under the *Busch* construction all the issuer must do to demonstrate an issue at rest is to prove the residence of original purchasers¹⁸³ and avoid sales under circumstances that indicate a plan of evasion.¹⁸⁴

179. SEC Supplemental Brief, *supra* note 169, at 6. See generally 7 J.W. Hicks, *supra* note 26, § 4.09.

180. 17 C.F.R. § 230.144(a)(3) (1987). See also John F. Davis, SEC No-Action Letter, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,240 (Dec. 19, 1972), in which the staff reported as the position of the Division of Corporation Finance that "the provisions of Rule 144 do not apply to the sale of securities acquired under Section 3(a)(11) of the Act." *Id.* at 82,719.

181. Rule 147(e) requires that "[d]uring the period in which securities that are part of an issuer are being offered and sold by the issuer . . ." all resales must be limited to residents. 17 C.F.R. § 230.147(e) (1987). See also Synbiotics Corp., No-Action Letter from SEC (July 22, 1985), [1985] Wash. Serv. Bur. Microfiche, fiche 942, frame C13 where the staff reiterated that "[p]rior to the expiration of the nine-month period, resales may be made only to other residents of the same state." *Id.* at E1.

182. 17 C.F.R. § 230.147(e) (1987).

183. The court stated that "[i]n the face of defendants' undisputed showing that all of the original buyers were Utah residents, plaintiffs were therefore required to produce evidence that the stock had not come to rest but had been sold to people who intended to resell it out of state." 827 F.2d 653, 657 (10th Cir. 1987). It noted that:

In their complaint, motion for summary judgment, and response to defendants' cross motion for summary judgment, plaintiffs consistently asserted that the stock issue had not come to rest only because it had been resold to non-residents within seven months. Plaintiffs did not assert that the original buyers were not Utah residents, or that these purchasers bought intending to resell rather than for investment purposes. Plaintiffs also did not assert that defendants' motion for summary judgment was deficient because defendants had not presented undisputed evidence of the original buyers' investment intent. The intent of the original purchasers was not the focus of the motions below, and allocation of the burden of showing this intent was not raised by the parties or addressed by the district court.

Id. at n.3.

184. The court distinguished cases cited by the SEC as authority for a traditional construction of the coming to rest doctrine, stating:

This is not a case like *Capital Funds*, 348 F.2d 582, in which a resident broker received stock without a subscription agreement, paid no consideration, resold to non-residents a few days later, and possibly earned a commission. See also *Stadia Oil & Uranium Co. v. Wheelis*, 251 F.2d 269 (10th Cir. 1957) (acquaintance of corporate officers persuaded non-residents to buy from resident broker who had received stock absent consideration and who earned commission on sales); *SEC v. Hillsboro Investment Corp.*, 173 F. Supp. 86 (D.N.H. 1958) (stock transferred out of state after being listed in name of resident for 30 days and before offering had closed).

No longer must an issuer in an intrastate offering place a restrictive legend on the certificate or other document evidencing the security or issue stop transfer instructions to its transfer agent. With this lighter burden of proof for the issuer come commensurate benefits for buyers. Interstate resales can begin more quickly. But, given the reasons for the liberalization, issuers and securityholders are not entitled to these improvements. They are the products of a misguided view of a section 3(a)(11) transaction and the proper purpose that resale limitations serve in that transaction.

B. Ralston Purina Criteria and Private Sales Under Section 4(1)

Section 4(2) exempts from the provisions of section 5 “transactions by an issuer not involving any public offering.”¹⁸⁵ The United States Supreme Court considered this exemption in *SEC v. Ralston Purina Co.*¹⁸⁶ and concluded that the applicability of section 4(2) “should turn on whether the particular class of persons affected need the protection of the Act.”¹⁸⁷ According to the Court, “[a]n offering to those who are shown to be able to fend for themselves is a transaction ‘not involving any public offering.’”¹⁸⁸

Ostensibly, section 4(2) has nothing in common with section 4(1). The private placement exemption, as section 4(2) is sometimes called, is available only to an issuer. Section 4(1) specifically excludes transactions by an issuer. The exemptions serve entirely different purposes. Nonetheless, a connection has been made between the two exemptive provisions. In addition to excluding transactions by an issuer, section 4(1) excludes transactions by an underwriter. The term “underwriter” is defined in section 2(11) to include any person who has purchased from an issuer (or an affiliate of an issuer) with a view to “the distribution of any security.” The term “distribution” in section 2(11) is not defined, but is equated with the phrase “public offering.” As a result, a claim that section 4(1) exempts a particular transaction by a person who is clearly not an issuer or dealer depends on whether his transaction, by itself or as part of a larger transaction, is or is not a “public offering.” If the transaction is one “not involving any public offering,” and it is not affected by the

Id. at 657. The SEC could not persuade the Tenth Circuit to reject the district court’s view that in the absence of any scheme to evade the statute through “straw man” transactions the exemption is satisfied by initial sales in state. According to the amicus brief, the district court developed this position from the unreported decision in *SEC v. Curtis Minerals*, *supra* note 173, in which a district court, without any inquiry into the intent of the purchasers, held that stock sold out of state within one month of the initial offering had come to rest in-state where no scheme to evade the statute had been shown. SEC Brief, *supra* note 154, at 12. The SEC argued:

Curtis Minerals, we submit, was incorrectly decided. It was apparently based on a misreading of this Court’s decision in *Stadia Oil & Uranium Co. v. Wheelis*. In *Stadia*, this Court concluded that a scheme to sell securities to out-of-state residents through sham sales to an in-state broker destroyed the intrastate exemption. 251 F.2d at 275. That decision, however, did not suggest that a scheme to evade the statute is invariably a prerequisite for the conclusion that the intrastate exemption has not been satisfied.

Indeed, such an interpretation would eviscerate the limitation of the exemption to truly local offerings to local investors. If the issuer could qualify its offering for the exemption by merely turning a blind eye to who was purchasing, ostensibly local offerings could readily become interstate offerings through resales by purchasers, such as broker-dealers, who might have no investment intent.

Id. at 12–13.

185. 15 U.S.C. § 77d(2) (1981).

186. 346 U.S. 119 (1953).

187. *Id.* at 125.

188. *Id.*

issuer or a dealer, it qualifies under section 4(1). The practical problem is how to determine whether an offering by a person who insists that he is not an underwriter was in fact "public" or "private." Some courts have found the answer in the judicial construction of section 4(2).¹⁸⁹ These courts, which take their cue from the Second Circuit decision in *Gilligan, Will & Co. v. SEC*,¹⁹⁰ impose transfer limitations on certain securityholders that are usually confined to an issuer.

The administrative action against Gilligan, Will & Co., a registered broker-dealer, and its two partners followed an offering by Crowell-Collier of three million dollars of its five percent convertible debentures in reliance on the private placement exemption.¹⁹¹ Gilligan purchased \$100,000 of the debentures from an agent of the issuer representing that he was acquiring them for his own investment account and not for distribution. Within one month, however, Gilligan sold one-half of the debentures to two friends, Louis Alter and Michael Mooney, and placed another \$5,000 of debentures in the registrant's trading account. Approximately one year later, Gilligan, the registrant, and the other two subpurchasers converted the debentures into common stock and sold the stock at a profit on the American Stock Exchange.¹⁹²

The Commission in its administrative decision found that the respondents were underwriters with respect to the 1955 and 1956 transactions in Crowell-Collier debentures and stock and suspended them from the NASD for five days.¹⁹³ On appeal, petitioners asserted that they were not "underwriters," as defined in section 2(11), and that, therefore, they were entitled to the ordinary trading exemption which was then located in the first clause of section 4(1).¹⁹⁴ They disclaimed any reliance on the second clause of section 4(1), *i.e.*, the private placement exemption presently located in section 4(2). Petitioners contended that the resale transactions were distinct and separate from the offering by the issuer, Crowell-Collier, and argued that whether there was a distribution "must be judged solely by their own acts and intention, and not by the acts or intention of the issuer or others."¹⁹⁵ According to the court, the petitioners' legal theory boiled down to this: "[W]hether the total offering was in fact public, their purchases and sales may be found to be exempt on the ground that they

189. See, e.g., *Leiter v. Kuntz*, 655 F. Supp. 725, 729 (D. Utah 1987); *Neuwirth Inv. Fund, Ltd. v. Swanton*, [1975-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,372 (S.D.N.Y. 1975); *SEC v. National Bankers Life Ins. Co.*, 334 F. Supp. 444 (N.D. Tex. 1971), *aff'd*, 477 F.2d 920 (5th Cir. 1973); *SEC v. Computronic Indus. Corp.*, 294 F. Supp. 1136 (N.D. Tex. 1968); *Hirstenstein v. Tenny*, 252 F.Supp. 827 (S.D.N.Y. 1966); *Value Line Fund, Inc. v. Marcus*, [1964-66 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,523 (S.D.N.Y. 1965); *Fuller v. Dilbert*, 32 F.R.D. 60 (S.D.N.Y. 1962).

190. 267 F.2d 461 (2d Cir. 1959), *cert. denied*, 361 U.S. 896 (1959). Although the Second Circuit's decision in *Gilligan, Will & Co.* is usually cited as the first major opinion that linked *Ralston Purina* criteria with § 4(1), an earlier case had already made the connection. *Collier v. Mikel Drilling Co.*, 183 F. Supp. 104, 110-12 (D. Minn. 1958) (the court concluded that secondary sales were not public offerings within the meaning of the Act).

191. *In re Gilligan, Will & Co.*, Exchange Act Release No. 5689 [1957-61 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,584 (May 7, 1958). The administrative action against Gilligan, Will & Co. was only one of three such actions against registered broker-dealers growing out of the Crowell-Collier offering. See also *In re Elliott & Co.*, Exchange Act Release No. 5688 [1957-61 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,583 (May 7, 1958); *In re Dempsey & Co.*, Exchange Act Release No. 5690, [1957-61 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,585 (May 7, 1958).

192. *In re Gilligan, Will & Co.*, *supra* note 191, at 80,260.

193. *Id.* at 80,263-64.

194. *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 466 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959). In 1964, Congress renumbered the provisions of § 4 and denominated what had been the first clause of § 4(1) as § 4(1) and the second clause of § 4(1) as § 4(2). Act of Aug. 20, 1964, 78 Stat. 580, §12.

195. *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 466 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959).

were not underwriters if their own resales did not amount to a public offering.”¹⁹⁶ The Second Circuit disagreed with the petitioners’ characterization of their resales as nonpublic and affirmed the Commission’s order. It found that “the resales contemplated and executed by petitioners were themselves a distribution or public offering as the latter term has been defined by the Supreme Court, and we therefore find that petitioners were underwriters and that their transactions were not exempt under § 4(1).”¹⁹⁷

The analysis that led to the Court’s conclusion began with the following statement of what it considered was the applicable law:

In *S.E.C. v. Ralston Purina Co.*, 1953, 346 U.S. 119, 73 S. Ct. 981, 97 L. Ed. 1494, the Supreme Court considered the exemptions provided by § 4(1). Two of its holdings are significant here. First, it held that an issuer who claims the benefit of an exemption from § 5 for the sale of an unregistered security has the burden of proving entitlement to it. The rationale of this result applies as well to a broker-dealer who claims the benefit of a similar exemption. We therefore find that the burden was upon the petitioners to establish that they were not underwriters within the meaning of § 4(1).

The Court also defined the standard to be applied in determining whether an issue is a public offering. It held that the governing fact is whether the persons to whom the offering is made are in such a position with respect to the issuer that they either actually have such information as a registration would have disclosed, or have access to such information. 346 U.S. at pages 125–127, 73 S. Ct. at pages 984–85.¹⁹⁸

Turning to the facts as stipulated, the Court found that the relationship between Gilligan and the firm, as sellers, and the friends to whom petitioners had sold the unregistered debentures did not meet the *Ralston Purina* criteria for a nonpublic offering:

[T]he purchasers “were not supplied with material information of the scope and character contemplated by the Securities Act nor were the purchasers in such a relation to the issuer as to have access to such information concerning the company and its affairs.” Such a stipulation . . . concedes the very proposition of which the petitioners had to establish the negative in order to prevail, and we therefore think it dispositive of the question whether petitioners “purchased . . . with a view to . . . distribution.”¹⁹⁹

The Second Circuit opinion yielded the correct result but it also created unnecessary confusion. Several courts have relied on the *Gilligan, Will & Co.* decision as authority for requiring any person who claims a section 4(1) exemption for an allegedly nonpublic offering to prove that his transaction conformed to the standards outlined by the Supreme Court in *SEC v. Ralston Purina*.²⁰⁰ This line of cases and the proposition that they support can be traced to the Second Circuit’s interpretation of *Ralston Purina*. The petitioners in *Gilligan, Will & Co.* made it clear that they were relying on the first clause of section 4(1)—*i.e.*, the ordinary trading exemption—and not on the second clause of section 4(1)—*i.e.*, the private placement

196. *Id.*

197. *Id.*

198. *Id.*

199. *Id.* at 466–67.

200. See cases listed *supra* note 191.

exemption.²⁰¹ Nonetheless, the Second Circuit concluded that the two exemptions were similar and decided that the Supreme Court's holdings in *Ralston Purina* were applicable to both exemptions.

A careful reading of *SEC v. Ralston Purina* reveals that the Second Circuit was incorrect on this point. The second clause of section 4(1) was the only exemption before the Supreme Court for judicial interpretation in *Ralston Purina*.²⁰² In construing that exemption, the Supreme Court stated:

The natural way to interpret the private offering exemption is in light of the statutory purpose. Since exempt transactions are those as to which "there is no practical need for [the bill's] application," the applicability of § 4(1) should turn on whether the particular class of person affected needs the protection of the Act. An offering to those who are shown to be able to fend for themselves is, a transaction "not involving any public offering."²⁰³

Presumably, it was this quoted passage from *Ralston Purina* that the Second Circuit relied on for its conclusion that the Supreme Court was interpreting all of the exemptions in section 4(1).²⁰⁴ In any event, the Second Circuit read into *Ralston Purina* more than the Supreme Court had specifically held. It is possible that the Supreme Court intended the statement "the applicability of § 4(1) should turn on whether the particular class of persons needs the protection of the Act," in its opinion to apply to all of the exemptions then subsumed under section 4(1). In the context of the Supreme Court's reason for granting certiorari, *i.e.*, "an apparent need to define the scope of the private offering exemption,"²⁰⁵ such a liberal construction of the Court's statement seems unintended and is certainly not part of the Court's holding.

The Second Circuit's expansive reading of *Ralston Purina* cannot be explained by the absence of an alternative doctrine to regulate petitioners' conduct. The availability of controlling authority could not have been more convenient. In its own decision to suspend Gilligan, Will & Co. and in its brief to the Second Circuit, the Commission had provided the court with two theories for applying the *Ralston Purina* standards properly.

In the administrative forum, Gilligan, Will & Co. and its partners contended that their resales were distinct from the transactions of others.²⁰⁶ It was in the context of this defense by respondents that the Commission discussed the Supreme Court's criteria for a valid private placement. The SEC determined that respondents were part of the primary offering, and that unless all of the purchasers of debentures from persons who were in the first level of the issuer's offering—including respondents—qualified under the criteria of *Ralston Purina*, the issuer's claim to a private placement exemption had to fail and respondents would then become underwriters in a public distribution. According to the SEC, respondents' entitlement to the benefits

201. *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 466 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959).

202. *See SEC v. Ralston Purina*, 346 U.S. 119, 120 (1953) (the Court framed the issue with respect to the second clause of § 4(1)).

203. *Id.* at 124–25.

204. The Second Circuit did not cite any specific page in *Ralston Purina* as authority for the conclusion that "the Supreme Court considered the exemptions provided by § 4(1)."

205. *SEC v. Ralston Purina*, 346 U.S. 119, 120 (1953).

206. 38 S.E.C. 388, 393 (1958).

of an exemption under the first clause of section 4(1) depended on their ability to demonstrate the issuer's right to an exemption under the second clause of section 4(1) as construed by the Supreme Court in *Ralston Purina*.²⁰⁷

The Commission's second theory for concluding that petitioners had failed to prove that their transactions were exempt was based on one of the holdings in *SEC v. Chinese Consolidated Benevolent Association*.²⁰⁸ In its brief in response to Gilligan, Will & Co.'s appeal, the Commission asserted that petitioners were participants in a public offering by Crowell-Collier that did not comply with section 5.²⁰⁹ According to the SEC, "if Crowell-Collier did otherwise have an exemption, petitioners' activities by themselves foreclosed the exemption."²¹⁰ With the loss of a private placement exemption for the issuer, the petitioners, who "were . . . clearly a primary channel for the distribution of Crowell-Collier securities to the public,"²¹¹ were in the same position as the Association in *Chinese Consolidated*. As persons who were "engaged in steps necessary to the distribution of unregistered securities," they lost their right to an exemption under the first clause of section 4(1). Under this theory, petitioners could have prevailed in their claims for an exemption had they been able to demonstrate that the entire offering, including their part, was nonpublic. Had they shown that the offering was nonpublic, in accordance with the criteria articulated by the Supreme Court, the petitioners would have established a valid private placement exemption for Crowell-Collier and thereby would have made it impossible for them to be deemed participants in a nonexempted and unregistered distribution. Petitioners, however, were unable to qualify for the issuer's offering under the *Ralston Purina* standards.

Both theories advanced by the SEC in its brief to the Second Circuit recognize that sections 4(1) and 4(2) are separate and distinct transactional exemptions. Unfortunately, neither of these theories was included in the court's opinion. Furthermore, these two theories properly explain the limited relationship between *Ralston Purina* and a claim to a section 4(1) exemption.

The *Ralston Purina* standards are relevant to a determination of whether a transaction by a person other than an issuer or dealer is exempted by section 4(1) only where the person claiming that exemption allegedly (i) purchased from the issuer with a view to distribution, (ii) sold for the issuer in connection with a distribution, or (iii) participated in a distribution by an issuer. In these situations, the person claiming an exemption under section 4(1) must overcome the allegation that the issuer was engaged in an unregistered public offering and that he, the claimant, either functioned as a statutory underwriter for the issuer or participated with the issuer in a significant

207. *Id.* at 392-93.

208. 120 F.2d 738, 741 (2d Cir.), *cert. denied*, 314 U.S. 618-19 (1941).

209. Brief for the SEC, 267 F.2d 461 (2d Cir.), *cert. denied*, 361 U.S. 896 (1959) [hereinafter SEC Gilligan Brief], at 15-17. The SEC contended that the administrative decision was based on this theory, despite the fact that *Chinese Consolidated* was not discussed in 38 S.E.C. 388, Exchange Act Release No. 5688. In its brief, the Commission asserted: "But the Commission did not rest alone on petitioners' failure to meet its statutory burden [*i.e.*, proving that they were not underwriters]. The Commission concluded from the incontrovertible facts in the stipulation that petitioners in their own activities participated in a distribution or a public offering." *Id.* at 25.

210. *Id.* at 25.

211. *Id.*

way. If the claimant can establish that the offering by the issuer was nonpublic (*i.e.*, not a distribution) and was exempted by section 4(2), he will be entitled to a section 4(1) exemption. Where the claimant adopts this approach, it is appropriate for the SEC or a court to assess the entire transaction, including the offers and sales by the person seeking the protection of section 4(1), in the light of the criteria and standards that have evolved under section 4(2) and decide whether the issuer's offering was in fact exempted under the private placement exemption.²¹²

The *Ralston Purina* criteria have no relevance to a case in which the person claiming a section 4(1) exemption allegedly participated in a secondary distribution not involving the issuer. Several cases that purport to be based on *Gilligan, Will & Co.* reach the opposite conclusion.²¹³ However, since all of these cases did not involve an alleged distribution by the issuer, section 4(2) was irrelevant. The person seeking the ordinary trading exemption, who allegedly (i) purchased from an affiliate with a view to distribution, (ii) sold for the affiliate in connection with a distribution, or (iii) participated in a distribution by an affiliate, must establish that the affiliate's offering did not constitute a "distribution" for purposes of section 2(11). By showing that the affiliate's offering was exempted by section 4(1), the reseller establishes his right to that same exemption. Since an affiliate cannot rely upon section 4(2) to exempt a nonpublic offering, any application of the *Ralston Purina* criteria in determining the reseller's right to section 4(1) is misplaced.²¹⁴

C. Underwriter Status in Registered Rule 145 Transactions

Ordinarily a purchaser of securities in a registered public offering does not experience resale limitations arising out of that acquiring transaction. An important exception to this general proposition occurs when certain securityholders acquire registered securities in a rule 145 transaction. As explained earlier,²¹⁵ the Commission has adopted the position, formally reflected in rule 145(c),²¹⁶ that persons who are affiliates of business entities which are acquired pursuant to the rule will be deemed to be statutory underwriters of the acquiring company's securities that they receive in that transaction if they resell them to the public. Paragraph (d) of the rule permits eligible holders of registered securities acquired in a rule 145 transaction to avoid underwriter status by reselling those securities in accordance with prescribed limitations that can include holding period requirements.²¹⁷ For purposes of rule 145(c), it is irrelevant that the person deemed to be an underwriter has no affiliation with the issuer or that he received an insignificant amount of the securities that were

212. For an example of a judicial opinion that properly invoked the *Ralston Purina* criteria, see the court of appeals opinion in *Lively v. Hirschfeld*, 440 F.2d 631 (10th Cir. 1971).

213. See *supra* note 189.

214. The SEC has also misapplied *Ralston Purina* criteria to a secondary distribution. See *In re Gearhart & Otis, Inc.*, 42 S.E.C. 1, 5-8 (1964), *aff'd sub nom.*, *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798 (D.C. Cir. 1965).

215. See *supra* text accompanying notes 132-36.

216. 17 C.F.R. § 230.145(c) (1987). For the full text of paragraph (c), see *supra* note 134.

217. 17 C.F.R. § 230.145(d) (1987). For the full text of paragraph (d), see *supra* note 136.

used to effect the business combination. The rationale for this administrative interpretation of section 2(11) can be traced to the no-sale theory and rule 133.²¹⁸

The no-sale rule developed as an administrative interpretation of the definitions contained in section 2(3) within the context of those business combinations where (1) the vote or consent of a majority of the stockholders in a disappearing company was required as a prerequisite for a merger, consolidation, or sale of assets, and (2) the vote or consent, once obtained, would be binding on all the stockholders except for the statutory appraisal rights for dissenters.²¹⁹ It proceeded on the theory that in such transactions a decision to relinquish securities in return for the acquiring company's securities was essentially a corporate act and that the volitional act on the part of the individual stockholder required for a "sale" was missing. The basis of this theory "was that the exchange or alteration of the stockholder's security occurred not because he consented thereto but because the corporate action, authorized by a specified majority of the interests affected converted his security into a different security."²²⁰ The no-sale rule provided the participants in a business combination with two benefits, only one of which carried an administrative blessing. As a result of the no-sale rule, the registration provisions of section 5 had no application to the securities transaction between the issuer of the securities (*i.e.*, the surviving party to the combination) and the stockholders in the disappearing company. In addition, the no-sale rule had the unintended side effect of weakening traditional criteria for determining underwriter status under section 2(11). If the securities transaction between the acquiring company and the stockholders of the disappearing company did not constitute a "sale," as provided for under the no-sale rule, it seemed to follow that none of the recipients of the acquiring company's securities could be viewed as having "purchased" securities from the issuer with a view to their distribution, within the meaning of section 2(11). The logic of this argument was not lost on the business community, with the result that unrestricted resales by recipients of unregistered securities developed into a serious problem for members of the investing public who had little or no information about an issuer.

The no-sale rule was formalized in 1951 as rule 133, but did not contain any provision for limiting resales by recipients.²²¹ During the succeeding eight years, and especially from 1956 through 1958, the Commission struggled with the abuses that were posed by unregulated resales of rule 133 securities.²²² The problem usually

218. 17 C.F.R. § 230.133 (1987) [hereinafter rule 133]. For an overview of the no-sale theory and rule 133, see Purcell, *A Consideration of the No-Sale Theory Under the Securities Act of 1933*, 24 BROOKLYN L. REV. 254 (1958) [hereinafter Purcell]; Sargent, *A Review of the "No-Sale" Theory of Rule 133*, 13 BUS. LAW. 78 (1957).

219. Securities Act Release No. 493(c) 1 Fed. Sec. L. Rep. (CCH) ¶ 3090.566 (Sept. 20, 1935). See Purcell, *supra* note 218, at 257.

220. New Rules Relating to Business Combinations, Securities Act Release No. 5316 [1972-73 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,015, at 82,198 (Oct. 6, 1972) [hereinafter Release No. 5316]. rule 145 became effective January 1, 1973. *Id.* at 82,205. The no-sale theory was rescinded and rule 133 only continued to apply to the completion of certain transactions submitted for shareholder consent before January 1, 1973. *Id.*

221. "No-sale" theory, Securities Act Release No. 33-3420, 1 Fed. Sec. L. Rep. (CCH) ¶ 3090.565, at 3113-8 (Aug. 2, 1951).

222. The Commission's battle to close the loopholes in rule 133 was fought at two levels, in litigation and in a series of proposed revisions to the no-sale rule. The two most important legal actions were SEC v. Micro-Moisture Controls, Inc., 148 F. Supp. 558 (S.D.N.Y. 1957) (the court concluded the "Rule 133 is not applicable to an 'exchange' of assets

emerged as the last in a series of steps by a private company seeking to use rule 133 as the way of "going public" without complying with the registration requirements of the Act. In these especially troublesome cases,

persons in control of a company wishing to dispose of its stock to the public without registration (which controlling stockholders cannot do), arrange for its merger etc., into a second company which, under Rule 133, does not require registration; as a result of such merger etc., they became a minority, *i.e.*, noncontrolling stockholders, of the surviving company; they then can . . . legally dispose of their minority interests in the surviving company without registration.²²³

The Commission's first systematic solution to the problem was announced in a 1959 release in which the agency reaffirmed the no-sale theory. But the release also announced the adoption of an amendment to rule 133 that provided for registration in those situations in which securities previously issued in a rule 133 transaction were offered to the public by any person who, under a new provision of the rule, was designated an underwriter.²²⁴ The new paragraph, rule 133(c), interpreted the statutory term "underwriter" to include those persons in a control relationship with any party to the business combination who acquired securities in a rule 133 transaction "with a view to the distribution thereof."²²⁵ In deciding to use an administrative interpretation of the section 2(11) definition as the basis for regulating some of the resale transactions in rule 133 securities, the Commission was necessarily challenging many of the implications of a no-sale theory that it continued to support. In doing so, the SEC found itself in the difficult position of defending a construction of the Act that contained logical inconsistencies.²²⁶ In May 1972, after further study,²²⁷ the Commission finally decided to abandon the "no-sale theory"

for stock which is but a step in the major activity of selling the stock"); *In re Great Sweet Grass Oils Ltd. & Kroy Oils Ltd.*, Securities Exchange Act Release No. 5483 [1957-61 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,516 (April 8, 1957). For a critical discussion of these two cases, see Purcell, *supra* note 218, at 261-69. Efforts to revise rule 133 during the period from 1956 to 1958 include: Notice of Proposed Amendment of Rule 133, Securities Act Release No. 3965 [1957-61 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,609 (Sept. 15, 1958); Notice of Proposed Revision of Rule 133, Securities Act Release No. 3698 [1952-56 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,409 (Oct. 2, 1956); Referral of Action of Proposed Revision of Rule 133, Securities Act Release No. 3761 [1957-1961 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,510 (March 15, 1957); Letter of SEC Concerning Rule 133, Securities Act Release No. 3762 [1957-61 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,511 (March 15, 1957).

223. *Memorandum of Subcommittee of the Committee on Federal Regulation of Securities of the Section of Corporation, Banking & Business Law of the American Bar Association* (Mar. 25, 1957), quoted in Purcell, *supra* note 218, at 288.

224. SEC Securities Act Release No. 4115 (July 16, 1959). Amended rule 133(c) stated:

(c) Any constituent corporation, or any person who is an affiliate of a constituent corporation at the time any transaction specified in paragraph (a) is submitted to a vote of the stockholders of such corporation, who acquires securities of the issuer in connection with such transaction with a view to the distribution thereof shall be deemed to be an underwriter of such securities within the meaning of Section 2(11) of the Act. A transfer by a constituent corporation to its security holders of securities of the issuer upon a complete or partial liquidation shall not be deemed a distribution for the purpose of this paragraph.

225. *Id.* The source of this aspect of the 1959 amendment to rule 133 appears to be the Commission's interpretation of the rule in *In re Great Sweet Grass Oils Ltd. & Kray Oils, Ltd.*, *supra* note 222, at 80,071. *Cf.* Purcell *supra* note 218, at 265-66. For an illustration of rule 133(c) in operation, see *SEC v. Spectrum, Ltd.*, [1972-73 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,631, at 92,865 (S.D.N.Y. 1972), *rev'd* 489 F.2d 535, 537 (2d Cir. 1973).

226. *See, e.g.*, Throop, *Recent Developments with Respect to Rule 133*, 15 Bus. Law. 119, 122 (1959).

227. *See, e.g.*, Wheat Report, *supra* note 12, at 248-96, which, in 1969, recommended that the Commission abandon the no-sale rule and replace it with mandated disclosure appropriate for the circumstances; Proposed Revision of Rule 133 Securities Act Release No. 5012 [1969-70 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,748 (Oct. 9, 1969).

embodied in rule 133 because it "overlooks the substance of the transactions specified therein and ignores the fundamental nature of the relationship between the stockholders and the corporation and between stockholders."²²⁸

In its place, the Commission recommended the adoption of a "sale theory" for business combinations that contemplated the use of a registration statement specifically tailored for these transactions. The proposed regulation, designated rule 145, contained a paragraph that would have imposed statutory underwriter status on certain stockholders of the disappearing company. However, instead of identifying underwriters by reference to control relationships that prospective recipients had within the disappearing company, proposed rule 145(c) would have defined recipients as underwriters solely by virtue of the amount of securities acquired in the transaction²²⁹—a concept that was very similar to the presumptive underwriter doctrine that the SEC staff had developed for a similar problem.²³⁰ By October 1972, when rule 145 was formally adopted,²³¹ the Commission had reconsidered the wisdom of defining underwriter status through objective standards²³² and returned to "criteria patterned after those now contained in rule 133."²³³ As the Commission explained in the release announcing the adoption of rule 145:

Revised paragraph (c) of the Rule provides that any party to any transaction specified in Rule 145(a), other than the issuer, or any person who is an affiliate of such party at the time any

228. Proposed Rescission of Rule 133, Securities Act Release No. 5246 [1971-72 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,753, at 81,567 (May 2, 1972).

229. Proposed rule 145(c) stated:

(c) For the purposes of this rule, any person who offers or sells registered securities acquired in a transaction specified in paragraph (a) of this rule shall be deemed to be engaged in a distribution and therefore to be an underwriter of such securities, within the meaning of § 2(11) of the Act, if the amount of securities acquired in such transaction exceeds the following:

(1) If securities of the same class are admitted to trading on a national securities exchange, the lesser of (A) one percent of the shares or other units of the class outstanding as shown by the registration statement, or (B) the average weekly reported volume of trading in such securities on all securities exchanges during the four calendar weeks preceding the effective date of such statement; (2) If securities of the same class are not traded on a national securities exchange but are traded in the over the counter market, one percent of the shares or other units of the class outstanding as shown by the registration statement; or (3) If on the effective date of the registration statement there is no public trading market for the securities of the class covered by the registration statement, five percent of the shares or other units of such class registered.

Id. at 81,574.

230. *See supra* note 130.

231. Release No. 5316, *supra* note 220.

232. The Commission offered the following explanation for rejecting proposed rule 145(c):

Rule 145(c), as proposed, contained specific criteria designed to clarify the underwriter status of persons who acquire substantial amounts of securities in a business combination registered on Form S-14, and who desire to resell such securities. The public comments on the proposal noted legal and policy arguments against any interpretation that imposes statutory underwriter status on persons solely by virtue of their receiving more than a certain amount of securities in a business combination. In addition, technical problems were cited in the application of the percentage tests in proposed Rule 145(c), and it was suggested that underwriter's liability should not be imposed on persons who may not be in a position to perform any necessary due diligence investigation. Others described the practical and regulatory problems that would arise if banks, investment companies, arbitrageurs and others enter into a Rule 145 transaction with marketable securities, but receive securities subject to trading restrictions. Because the question of the underwriter status of persons taking substantial portions of registered offerings arises in connection with all registered offerings, the Commission believes that the matter should be dealt with in a more comprehensive manner after further study, and not just in the limited context of business combinations.

Id. at 82,201-202.

233. *Id.* at 82,202.

such transaction is submitted for vote or consent, who offers or sells securities acquired in such transaction, shall be deemed to be engaged in a distribution and therefore an underwriter, except with respect to the limited resales permitted pursuant to paragraph (d) of Rule 145. Moreover, from a practical standpoint, because such persons usually are in a position to verify the accuracy of information set forth in the registration statement, and usually are in a position to influence the transaction, the Commission believes that this provision is not unreasonably burdensome.²³⁴

The indication in the Commission's explanatory release is that rule 145(c) is patterned after rule 133(c), as amended in 1959.²³⁵ Under both rules, the question of underwriter status for recipients of securities in a business combination is resolved "at the time any such transaction is submitted for vote or consent." The inquiry at that critical moment in the preliminaries to the actual issuance of securities by a surviving company is whether a prospective recipient is an affiliate of the company that is being acquired. The Commission's decision to rely upon rule 133(c) in delineating its regulation for resales of securities issued in rule 145 transactions ignores the relationship that must exist between the transfer restrictions that necessarily follow from underwriter status and the transaction that is responsible for them.

As previously noted, rule 133(c) was designed as a protective measure against indirect distributions of unregistered securities. It reflected a judgment, borne out in practice, that for those persons who were in a position to influence the acquired company, and thus to influence the transaction, the acquisition and disposition of the acquiring company's securities did not have to be distinct and separate transactions. Paragraph (c) of rule 133 prevented affiliates of private companies from arranging a business combination with a public company and transforming themselves into nonaffiliates with marketable securities that they could immediately liquidate. It also reflected a concern for public investors who inevitably became subpurchasers in a distribution by an issuer that lacked the disclosure that accompanies a registered offering. Regardless of its logical inconsistencies, rule 133(c) was defensible when tested against the purposes of the Act.

However, rule 145 proceeds on an entirely different theory. It reaffirms the literal application of section 5 to business combinations and assures the protections of that provision for affiliates and nonaffiliates of an acquired company and, indirectly, for subpurchasers in the after market. Where the business combination is accomplished by means of an effective registration statement, the acquiring company's transaction is defined by the various delivery and reporting obligations that the statute and administrative rules exact from an issuer. In this context, where the issuer has done all that the Act requires, resales by recipients of the registered securities are clearly distinct and should proceed with whatever freedom for securityholders that ordinarily follows any other registered offering. Nothing in the Act compels that a person acquiring a substantial part of a registered offering should be treated differently from any other investor with a large investment interest in the issuer unless

234. *Id.*

235. Rule 133(c) contained a condition for underwriter status that was omitted from rule 145(c). Rule 133(c) identified as an underwriter any affiliate of the disappearing company who acquired securities "with a view to the distribution thereof." *Id.* at 82,202.

the purchaser becomes an affiliate as a result of the purchase. When a purchaser becomes an affiliate because of his additional holdings, the resale limitations that await him will arise not from his acquiring transaction, but from his status vis-a-vis the issuer and from the nature of his transferring transaction.

The Commission's traditional response to suggestions that it adopt a policy that would insulate all purchasers of registered securities from underwriter status is to point to the practical implications of that approach. In the area of business combinations the primary administrative concern has been with the acquisition of a company that has a small number of securityholders.²³⁶ Suppose, for example, that an acquiring company uses a significant amount of its registered securities to purchase the business assets of a company that is owned by one person but he or she does not end up as an affiliate of the issuer. Because the Commission is concerned that the owner of the acquired company might sell publicly all of the acquiring company's securities free of any prospectus delivery duties, it has not wanted to say that the distribution ended with the affiliate of the acquired company. In a registered offering of this dimension the affiliate who negotiated the transaction with the acquiring company is like the buyer in a private placement and, in the SEC's opinion, should suffer the same underwriter taint. Although the Commission's concern is legitimate, the solution, as expressed in rule 145(c), is inappropriate. Paragraph (c) does not discriminate between registered offerings that are truly public and those that are essentially private. Nor does it distinguish between acquiring companies that are subject to the periodic reporting requirements of the Exchange Act, where disclosure to public investors is continuous, and those that are not subject to periodic reporting and find their disclosure obligations ending with the securityholders of the acquired company. For those registered offerings to securityholders of an acquired company that are actually public in nature the resale limitations created by rule 145(c) serve no purpose. Instead of the blunderbuss solution of rule 145(c) the remedy, to the extent that it is needed, should be tailored to the troublesome transactions that involve "public" registered offerings in name only. In this way the resale limitations that accompany underwriter status would be serving a purpose that is related to the issuer's transaction while at the same time ignoring those affiliates of an acquired company who should be viewed properly as the real public purchasers.

IV. PRACTICAL IMPLICATIONS OF THE THESIS

The registration and prospective delivery requirements of the 1933 Act were designed for transactions by issuers and affiliates that take the form of public offerings. In many securities transactions by these persons, both registered and unregistered, the objectives inherent in relevant regulations are fully attainable without the necessity for resale restraints.²³⁷ In certain transactions, however, an issuer or an affiliate structures its transaction in such a way that the underlying

236. The Commission's concern developed into a so-called negotiated transaction doctrine. See Wheat Report, *supra* note 12, at 262-66.

237. *E.g.*, Unregistered offerings that are effected by an issuer or an affiliate pursuant to Regulation A do not require resale restraints. 17 C.F.R. §§ 230.251-264 (1987).

purpose of the statutory or administrative regulations that apply to the transaction cannot be assured without the imposition of such restraints.²³⁸ To be sure an issuer or affiliate's choice of a particular transactional structure can be influenced by the knowledge that certain options carry resale limitations. But it is the nature of the transaction that determines the applicable regulation and it is the purpose of that statutorily based regulation that might call for an abridgment of a securityholder's right of free alienability. It is in this respect that resale limitations are inexorably linked to the transaction concept.

The preceding parts have explored this relationship by organizing limitations in terms of their origin in either an acquiring or transferring transaction, and by considering what can occur when a resale limitation is evaluated in the abstract or in isolation from the objective of the applicable regulation. In the remainder of this Article, I will discuss four of the implications of this relationship for those who establish or interpret resale limitation policy under the Act.

A. *Validity of Restraints*

The relationship that must exist between a resale limitation and the transaction out of which it flows has important implications in justifying particular restrictions. As stated above, in order for a resale limitation to be valid it must help significantly to effectuate the purpose of the statutorily based exemption or regulatory policy applicable to the originating transaction.

1. *Investment and Coming to Rest Requirements*

Where a transaction is initiated by an issuer or an affiliate, the statute and its legislative history justify regulatory measures that prevent it from becoming a distribution without the safeguards of registration. This means that issuer-imposed limitations of holding period requirements that arise because of reliance on rule 504 and 505, sections 4(2) and 4(6), of territorially prescribed trading that stem from sections 3(a)(11) and Release No. 4708,²³⁹ and affiliate-imposed restraints that are needed because of a claimed section 4(1-1/2) exemption are all defensible.²⁴⁰ In each of these transactions the policy underlying the exemption, which is traceable to a specific statutory provision, is furthered by a condition that restricts the free alienability of the securities sold.

2. *Volume, Manner of Sale, and Disclosure Requirements*

The remaining restraints concern volume, method of sale, and the availability of information about the issuer.²⁴¹ These limitations are embodied in varying degrees in rules 144 and 145, for use in connection with public resales, and in the suggested

238. *E.g.*, An issuer that confines its offering to residents of its state of organization and then claims an exemption under § 3(a)(11) must satisfy the coming to rest requirement before allowing interstate resales.

239. *See supra* text accompanying notes 86–104.

240. *See supra* text accompanying notes 143–46.

241. *See supra* text accompanying notes 17–20.

criteria for section 4(1-1/2), to be invoked in private resales. The validity of these restraints is discussed in terms of public and private resales.

a. *Public Resales by Affiliates*

Congress intended that the registration requirements apply to affiliates whether or not the securities were encumbered in the hands of the controlling person. It expressed this policy in section 2(11) by defining an underwriter as any person who either sells for an affiliate or purchases from an affiliate with a view towards distribution. Since an affiliate's public resales are likely to be made through agents and might evolve into a secondary distribution, and since a secondary public offering "may possess all the dangers attendant upon a new offering of securities,"²⁴² the SEC is fully justified in placing rule 144 restraints on an affiliate's transferring transaction. Thus, even though an affiliate intends to publicly resell unrestricted securities "all the dangers" of a new public offering are present and the limitations of rule 144(c), (e), (f), and (h) are warranted. The same can be said for his public resale of restricted securities that have been beneficially owned for such an extended period of time that no one doubts the termination of the acquiring transaction.²⁴³

b. *Public Resales by Nonaffiliates*

A nonaffiliate's resales of unrestricted securities are usually free of any restraint regardless of the volume, timing, or manner of sale. In those situations in which some version of the presumptive underwriter doctrine applies²⁴⁴ and the nonaffiliate must conform his resales to the volume limitations of rule 144(e), the restraints are traceable to the size of the holder's purchase in the acquiring transaction. But the volume limitations that the nonaffiliate faces serve no purpose in the regulation of the acquiring transaction. The limitations of rule 144(e) are intended to control the transferring transaction. However, the Commission lacks statutory authority to regulate a nonaffiliate's transferring transaction where the securities are unrestricted. The presumptive underwriter doctrine, therefore, is indefensible. The same reasoning and conclusion applies to the Commission's broad-based attempt to limit the quantity of a nonaffiliate's resales under rule 145(c) and (d).²⁴⁵

A nonaffiliate who intends to sell securities acquired from an issuer or an affiliate in a transaction in which a holding period limitation was imposed²⁴⁶ will be unable to claim section 4(1) if he is deemed to have (i) purchased from the issuer or affiliate

242. *Report of Committee on Interstate & Foreign Commerce*, H.R. REP. NO. 85, 73d Cong., 1st Sess. 13-14 (1933), quoted more fully *supra* in text accompanying note 47.

243. See *infra* text accompanying notes 247-48.

244. See *supra* text accompanying notes 126-31.

245. See *supra* text accompanying notes 215-36. H. KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* 248-63 (1979); Ahrenholz & Van Valkenberg, *The Presumptive Underwriter Doctrine: Statutory Underwriter Status for Investors Purchasing a Specified Portion of a Registered Offering*, 1973 UTAH L. REV. 773, 792-96.

246. See *supra* text accompanying notes 79-90; 142-46.

with a view to distribution, (ii) sold for the issuer or affiliate in connection with a distribution, or (iii) participated in a distribution by the issuer or affiliate. In order to avoid one or more of these inferences, a nonaffiliate holding restricted securities must be able to establish that the securities have come to rest in his hands and that, therefore, any resale constitutes a separate transaction from the original transaction by the issuer or affiliate. A nonaffiliate who retains beneficial ownership of such securities for a significant period of time provides objective evidence that he did not acquire the securities with a view to distribution, will not be selling them for the issuer or affiliate in connection with, or as a participant in, a distribution by the issuer or affiliate.²⁴⁷ The length of time that a securityholder retains beneficial ownership of restricted securities should be the only factor for determining the independence of his resale transaction.²⁴⁸

Rule 144(d) assists a nonaffiliate owner of restricted securities by fixing the minimum period of retention at two years. As discussed earlier, this resale limitation serves a valid purpose of the originating transaction and rule 144(d) adds useful clarification.²⁴⁹ But rule 144 imposes additional burdens as well. All of the restraints in paragraphs (c), (e), (f), and (h) are designed to regulate the nonaffiliate's transferring transaction and bear no relationship to the regulatory policies applicable to the acquiring transaction.²⁵⁰ Because the Commission has no statutory authority to regulate an independent transferring transaction by a nonaffiliate who is not an

247. *United States v. Sherwood*, 175 F. Supp. 480, 483 (S.D.N.Y. 1959).

248. Rule 144(k) supports this proposition. It eliminates all of the restraints of rule 144(c), (e), (f), and (h) from resales of restricted securities by a nonaffiliate "provided the securities have been beneficially owned by such person for a period of at least three years prior to their sale." 17 C.F.R. § 230.144(k) (1987). The propriety of a three-year holding period is a separate issue. See *infra* text accompanying note 266.

249. See 17 C.F.R. § 230.144(d)(2), (3), & (4) (1987).

250. In Release No. 5223, *supra* note 85, announcing the adoption of rule 144, the Commission offered the following justification for applying factors other than the length of time a person has held the securities:

[T]he Commission hereby emphasizes and draws attention to the fact that the statutory language of Section 2(11) is in the disjunctive. Thus, it is insufficient to conclude that a person is not an underwriter solely because he did not purchase securities from an issuer with a view to their distribution. It must also be established that the person is not offering or selling for an issuer in connection with the distribution of the securities and that the person does not participate or have a participation in any such undertaking, and does not participate or have a participation in any such underwriting of such an undertaking. . . . In view of the legislative history, statutory language and judicial interpretations of Sections 2(11), 4(1), and 4(2) of the Act, and in light of the many helpful suggestions and comments received on the proposed "160 Series" of rules and thereafter on proposed Rule 144, the Commission is of the view that "distribution" is the significant concept in interpreting the statutory term "underwriter." In determining when a person is deemed not to be engaged in a distribution several factors must be considered.

Id. at 81,053. The Commission is correct in noting the disjunctive nature of the four clauses in § 2(11) and in emphasizing that the claimant of a § 4(1) exemption must prove his entitlement by establishing that he is not an underwriter. However, as a practical matter, an ordinary securityholder is unlikely to be deemed to have offered or sold for an issuer or an affiliate—the first clause of § 2(11)—in the absence of an agreement with the issuer or affiliate. See generally 7B J.W. Hicks, *supra* note 26, § 9.02[3]. The other two categories of underwriter, clauses 3 and 4, are also unrealistic threats to a nonaffiliate holder of restricted securities. These two categories of "participants" in a distribution of securities appear to have been intended for certain professionals in the securities industry. See 7B J.W. Hicks, *supra* note 26, § 9.02[4]. With these categories eliminated for nonaffiliates, the nonaffiliate's only practical concern is how to establish that he did not purchase securities from an issuer or an affiliate with a view to their distribution. The holding period factor is the answer.

underwriter or participant in a distribution,²⁵¹ the nonholding period restraints of rule 144 cannot be justified.²⁵²

c. Private Resales by Affiliates

Congress did not choose direct regulation of secondary distributions.²⁵³ An affiliate loses his claim to section 4(1) by becoming an underwriter or by reselling significant amounts of securities through or with the assistance of an underwriter. Where an affiliate privately resells unrestricted securities, or restricted securities that have come to rest in his hands, to a limited number of person who do not take with a view towards distribution, he is entitled to claim the ordinary trading exemption. In order to avoid having his purchasers resell prematurely and thereby become underwriters, an affiliate must avoid general advertising or solicitation that would constitute offers to the public and must limit the timing of resales by his transferees. Where an affiliate takes these precautions with respect to sales of unrestricted securities, his transferring transaction does not constitute a distribution and neither he nor his transferee becomes an underwriter or a participant in a transaction by an issuer or underwriter. His private sale should be exempted from section 5 even where his purchaser is unsophisticated and without access to information about the issuer.²⁵⁴ Although the antifraud provisions of the 1933 and 1934 Acts require that an affiliate disclose to his private buyer any material nonpublic information concerning the issuer that he knows, nothing in the 1933 Act or its legislative history supports imposing a disclosure obligation on the affiliate as a condition for a section 4(1-1/2) exemption.

d. Private Resales by Nonaffiliates

A nonaffiliate's private resale of unrestricted securities is always exempted by section 4(1). Where a nonaffiliate resells restricted securities he will be ineligible for an exemption under section 4(1) if he is deemed to have (i) acquired the securities from an issuer or an affiliate with a view to distribution, (ii) sold them for the issuer or affiliate in connection with a distribution, or (iii) participated in a distribution by an issuer or affiliate. Once a nonaffiliate meets the holding period requirement that the issuer or affiliate has properly imposed on him, his resale transaction is distinct from the acquiring transaction.²⁵⁵ Section 4(1-1/2) should have no application after the

251. "Participation" as used in the text refers to the judicial construction of § 4(1) as developed in *SEC v. Chinese Consol. Benevolent Ass'n*, 39 F. Supp. 85 (S.D.N.Y. 1940), *rev'd*, 120 F.2d 738 (2d Cir.), *cert. denied*, 314 U.S. 618 (1941), discussed *supra* text accompanying notes 65-72. It has been confused with the terms "participates" and "participation" in the third and fourth clauses of § 2(11). See, e.g., *SEC v. International Chem. Dev. Corp.*, 469 F.2d 20, 33 (10th Cir. 1972). See generally 7B J.W. Hicks, *supra* note 26, § 9.02[4][b][iii].

252. H. KRIFKE, *supra* note 245, at 243-48.

253. See *supra* text accompanying notes 45-55.

254. Cf. *A Report to the Committee on Federal Regulations of Securities from the Study Group on Section "4 (1-1/2)" of the Subcommittee on 1933 Act, The Section "4 (1-1/2)" Phenomenon: Private Resales of "Restricted" Securities*, 34 BUS. LAW. 1961 (1979) [hereinafter ABA Report], at 1975-1976. *Contra* Olander & Jacks, *supra* note 141, at 363; Comment, *supra* note 141, at 700-02. As discussed *supra* text accompanying notes 185-214, the issue of a disclosure obligation within the context of § 4(1-1/2) has been linked to a determination of the proper scope of *SEC v. Ralston Purina*.

255. See *supra* text accompanying notes 247-48.

securities have come to rest. Thereafter, he should be free to resell restricted securities publicly or privately without having to impose any limitations on his purchaser.²⁵⁶

B. *Particularized Implementation*

The validity of a resale limitation does not guarantee its fairness for the type of transaction that it helps to regulate. To ensure that a restraint is not unnecessarily onerous for a securityholder, resale limitation policy should discriminate among the various categories of transactions in which a particular form of restraint may be imposed. It should also tailor specific characteristics of a restraint to the objectives of the governing regulations. These conditions of fairness are tested against holding period and coming to rest restraints, two types of limitations which I have judged to be valid for use in connection with certain transactions.²⁵⁷

Evidence of SEC concern for particularized implementation of resale policy is found in the application of the coming to rest doctrine. Instead of using an omnibus standard to define the phrase "coming to rest," the SEC has fashioned a definition that recognizes a purpose for the doctrine in a section 3(a)(11) transaction that is not the same when it is invoked in reference to a transaction that satisfies the conditions of Release No. 4708. As a result the doctrine yields different restraints. Purchasers in an intrastate offering must endure a ban on interstate trading for a period of either nine months or one year.²⁵⁸ On the other hand, foreign investors will find the offering in their acquiring transaction coming to rest as quickly as ninety days after the last sale by the issuer.²⁵⁹ However, the SEC apparently has ignored this principle of fairness in its treatment of the holding period requirement.

A mandatory period of retention accompanies securities that an issuer or affiliate transfers in a nonpublic offering or in issuer transactions under rules 504 or 505 of Regulation D.²⁶⁰ The SEC has determined in its formulation of rule 144(d)(1) that regardless of which exemption controlled the acquiring transaction, two years is the appropriate holding period for a beneficial owner of restricted securities. By adopting a single standard for securities that can attain restricted status in more than one way,²⁶¹ the Commission has overlooked the different purposes of the restraint. A holding period requirement is essential to sections 4(2) and 4(6); it is not required at all by section 3(b). Consequently, where the SEC determines to impose such a restraint on securities issued pursuant to a section 3(b) exemption, as it has under

256. ABA Report, *supra* note 254, at 1975-76.

257. See *supra* text accompanying notes 239-40. On November 22, 1986, Linda C. Quinn, Director of the SEC Division of Corporation Finance addressed the annual fall meeting of the Federal Regulation of Securities Committee. In her speech, entitled "Redefining 'Public Offering or Distribution' For Today," she described the administrative rules for determining when securities sold outside the registration process in the United States or overseas come to rest as being "all over the lot" and explained that "we've not yet started to wrestle with this issue." For reasons stated in the text, instead of being a detriment, such a diversity of holding periods is probably a necessity.

258. See *supra* text accompanying notes 91-97.

259. See *supra* text accompanying notes 98-104. See also 17 C.F.R. § 230.144(e)(1) (1987) where the three standards for calculating volume limitations under rule 144 reflect particularized implementation depending on the nature of the issuer and recent trading activity in its securities.

260. See *supra* text accompanying notes 79-90.

261. 17 C.F.R. § 230.144(a)(3) (1987).

rules 504 and 505, it is free to prescribe a retention period that bears no resemblance to the one it uses in other circumstances.

Even where a restraint is shaped to conform generally with the objectives of an exemption, fairness dictates that it be further refined. Consider, for example, the valid restraint that is required under section 3(a)(11). Although the Commission has contributed to the fairness of the coming to rest requirement by providing an objective test in rule 147(e), it is unclear why the SEC selected nine months as the prescribed duration of the limitation. Presumably the SEC wanted to encourage issuers to use rule 147 and intended the shorter ban on interstate trading to serve as an inducement. The one year moratorium, which applies for offerings outside the rule, is thought to be based on the *Brooklyn Manhattan Transit* case,²⁶² in which the Commission equated the life of an intrastate public offering with the duration of the average interstate public offering, as determined by Congress for purposes of a dealer's prospectus delivery obligations under the third clause of section 4(1).²⁶³ In 1954 Congress amended the dealers' exemption to require a dealer to deliver copies of a statutory prospectus for a period of forty or ninety days depending upon the nature of the registrant.²⁶⁴ If the Commission was correct in 1935 in equating the duration of the two restraints involved, an issuer's intrastate offering today should come to rest long before the time established by rule 147(e). It may well be that section 4(3) should not serve as the proxy for fixing the appropriate duration of a resale limitation under section 3(a)(11).²⁶⁵ But the precise term that is selected should be no more severe than is needed to achieve the intended objective. Also, it should come with an explanation that allows for a judgment on severity and reasonableness.²⁶⁶

The principle of particularized implementation has another aspect. The transactional nature of the registration controls should not be used to create or intensify a resale limitation where the purpose of an independent regulation is already being served. An illustrative threat to this element of fair resale limitation policy is a \$400,000 intrastate offering by a local issuer to ten sophisticated residents. Although

262. *In re Brooklyn Manhattan Transit Corp.*, 1 S.E.C. 147 (1935).

263. *Id.* at 162-63. See, e.g., 1 L. Loss, *supra* note 171, at 597. The Commission warned that the one year period should be seen as a presumption but not "as a conclusive presumption of law, as in the third clause of Section 4(1) of the Act, but as a presumption of fact subject to refutation upon a showing a fact that distribution was completed within less than one year." 1 S.E.C. 147, 162-63 (1935).

264. See H.R. REP. NO. 1542, 83d Cong., 2d Sess. 14 (1954): "The 1-year provision with respect to trading transactions has long been recognized as unrealistic." In 1964 Congress repositioned the dealers' exemption and renumbered it § 4(3). S. REP. NO. 379, 88th Cong., 1st Sess. 28-29 (1963); H.R. REP. NO. 1418, 88th Cong., 2d Sess. 31, 82 (1964).

265. See 1 L. Loss, *supra* note 171, at 597.

266. The duration of the holding period required for restricted securities should also be tested against the principles set forth in the text. In announcing the adoption of rule 144, the Commission acknowledged that there had been various holding periods provided for over the years by administrative interpretations. It then stated that "[a]fter reexamination and reconsideration, the Commission believes, in keeping with the purposes of the Act in preventing the distribution of unregistered securities to the public, that the holding period should be two years" for sales made under rule 144(e). Release No. 5223, *supra* note 85, at 81,057. See Schneider, *Acquisitions Under the Federal Securities Acts—A Program for Reform*, 116 U. PA. L. REV. 1323, 1337 (1968). For purposes of resales under rule 144(k) the holding period is three years. Although the SEC has not provided a rationale for the holding periods in rule 144 one commentator has suggested that because the informal two-year rule of thumb of *U.S. v. Sherwood*, 175 F. Supp. 480, 483 (S.D.N.Y. 1959) arose in a criminal case with higher standards of proof, "a longer holding period might arguably apply in a civil or SEC enforcement proceeding." T. HAZEN, *THE LAW OF SECURITIES REGULATION* 145 (1985).

the hypothetical issuer could rely on either rule 504 or section 4(2) for an exemption, it chooses section 3(a)(11) because of the shorter resale limitation for its purchasers. For a period of a few years in the 1970s the SEC staff viewed an offering to a limited number of persons as tantamount to a private placement and considered the securities that were issued as restricted for purposes of rule 144.²⁶⁷ As a result of this informal position, purchasers such as the ten investors in the illustration were expected to hold their securities for two years prior to public resale. As the staff eventually realized, selective application of a two year holding period requirement to any nonpublic offering obscured the decision by Congress to provide alternative regulatory patterns for an unregistered offering by an issuer, most of which make no reference to the number of offerees or purchasers. Where a transaction meets all of the conditions of an exemption, presumably it has satisfied all of the objectives of that regulation. An additional burden, borrowed from a different regulation, is unnecessary and invalid.

C. Clarity and Predictability

The costs of a resale limitation policy should not be compounded by confusion and uncertainty.²⁶⁸ The SEC deserves considerable praise for the clarity and predictability that it has brought to interpretations of such key terms as "distribution," "investment intent," "coming to rest," and "brokerage transactions."²⁶⁹ However, given the relationship that exists between the concept of transaction and resale limitations, an even more crucial term needs to be defined in terms that are consistent with legislative history and with the competing interests of enforcement flexibility and resale certainty.

Transferring transactions are the origin of several different forms of resale limitation. But these restraints arise only where the transferor is an affiliate.²⁷⁰ Some of the restraints that emerge from acquiring transactions owe their existence to the transferor's status as an affiliate.²⁷¹ Depending upon how the term "affiliate" is defined, federal resale limitation policy is either more or less intrusive. A review of SEC interpretation of this term for purposes of section 2(11) indicates an administrative view that is both imprecise and excessive.

267. See, e.g., *Golden Enters., Inc.*, No-action from SEC (Jan. 25, 1977), [1977] CCH Fed. Sec. Microfiche, fiche 6, frame D19 (Section 3(a)(9) transaction); *Acceleration Corp.*, No-action letter from SEC (Nov. 12, 1976), [1971-1976] Wash. Serv. Bur. Microfiche, fiche 67, frame E13 (section 3(a)(11) transaction); *Electronic Data Sys. Corp.*, No-action letter from SEC (May 14, 1975), [1971-1976] Wash. Serv. Bur. Microfiche, fiche 47, frame F2 (Section 3(a)(11) transaction).

268. See, e.g., *Wheat Report*, *supra* note 12, at 177:

The lack of objective tests to determine when and how shares issued in a non-public transaction may be offered publicly provides an unfortunate leeway for the unscrupulous. It has been the Commission's experience that unprincipled counsel will often give opinions on the availability of exemption for registration when careful or responsible counsel would not do so. The result of this is to put careful counsel at a marked disadvantage. The client's objective is immediate cash. The pressures are strong, and the temptation to cut the statutory corner is magnified by uncertainty.

269. With the exception of "coming to rest," all of these terms are clarified by rule 144. The coming to rest doctrine has been addressed in rule 147(d) and administrative interpretations of Release 4708.

270. See *supra* text accompanying notes 142-46.

271. See *supra* text accompanying notes 105-12.

The Act contemplates that some person or group of persons will be in control of every corporation or other business entity.²⁷² The concept of control, which is crucial to the regulation of secondary distributions, is not defined in the Act. To complicate the matter, the issue of what constitutes a control relationship arises in other contexts of the federal securities laws in which the reasons for the inquiry and the policy goals to be achieved are different.²⁷³ Judicial and administrative opinions on the meaning of control for purposes other than section 2(11) might be helpful, but they are not necessarily reliable when deciding whether a person is an affiliate in the context of a secondary distribution.²⁷⁴ Despite the absence of a statutory definition, the legislative history of section 2(11) does provide two important clues to the meaning of the undefined term.

First, it seems clear that Congress did not expect section 2(11) to bring within the registration requirements of the Act all redistributions of outstanding securities. Instead, it appears that Congress intended the scope of the definitional section, especially the last sentence, to be limited to redistributions by a person having such a relationship, direct or indirect, to the issuer as to be in a position to obtain registration by the issuer.²⁷⁵ Ideally, one might argue, the benefits of the registration process should have been extended to purchasers in every secondary distribution. As two early commentators on the exemptive provisions of the Act noted, however,

the limiting of the requirement of registration to those cases of secondary distribution in which registration by the *issuer* may be compelled is completely justified upon consideration of the practical difficulties inherent in the effecting of registration by a non-affiliated person, the probable inadequacy of any registration thus effected, and the public interest in not hampering the free interchange of outstanding securities in honest transactions.²⁷⁶

The second interpretative guideline to the meaning of the control concept in section 2(11) was stated explicitly in the legislative history. According to the report of the Committee on Interstate and Foreign Commerce, the concept of control "is not a narrow one, depending upon a mathematical formula of 51 percent of voting power,

272. See, e.g., American-Standard, SEC No-action Letter, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,071, at 82,313 (Oct. 4, 1972).

273. See, e.g., 15 U.S.C. §§ 77b(3) (exception to the definition of the term "offer to buy" for preliminary negotiations between an affiliate and certain underwriters), 77c(a)(2) (1976) (exemption for certain securities issued by an employer or by a company in a control relationship with the employer), 77o (1976) (liability of controlling persons), 77s (1976) (special powers of Commission in connection with balance sheets or income accounts of control persons), 77aa Schedule A(17) (1976) (required disclosure in registration statement of commissions paid, in connection with the sale of the security to be offered, by a control person), & 77p (1976) (liabilities of controlling persons), as amended. See also SEC Securities Act Form S-3, Gen. Instr. (I)(B)(1), 2 Fed. Sec. L. Rep. (CCH) ¶ 7,152, at 6252, where the Commission's transactional requirements for use of the form include a reference to the aggregate market value of voting stock held by non-affiliates.

274. See, e.g., *Moerman v. Zipco, Inc.*, 302 F. Supp. 439, 447 (E.D.N.Y. 1969), *aff'd*, 422 F.2d 871 (1970) (for purposes of determining liability under rule 10b-5, the court concluded that the "conclusion is inescapable that persons who act as directors are in control of the corporation"). See also *Vickers v. SEC*, 383 F.2d 343, 344 (2d Cir. 1967) (the court sustained the Commission's finding of control under rule 12b-2, 17 C.F.R. § 240.12b-2 (1987), under the Securities Exchange Act of 1934).

275. H.R. REP. NO. 85, 73d Cong., 1st Sess. 13-14 (1933). Section 6(a) of the Act requires that at least one copy of a registration statement filed under the Act be signed by the issuer. 15 U.S.C. § 77f(a) (1981).

276. Throop & Lane, *Some Problems of Exemption Under the Securities Act of 1933*, 4 LAW & CONTEMP. PROB. 89, 119 (1937).

but is broadly defined to permit the provisions of the act to become effective wherever the fact of control actually exists."²⁷⁷

The legislative history suggests that the following test be used to identify those persons who, because of their relationship to the issuer, should bear the burdens of registration in connection with a secondary distribution: Does the person possess the power to cause the issuer to file a registration statement?²⁷⁸ Power, for purposes of this test, can flow from stock ownership, management responsibility, or business and personal relationships.²⁷⁹ A person who meets the conditions of this test is treated under section 2(11) as equivalent to the original issuer, a characterization that is easier to comprehend in the case of a person who achieves the status by "directly or indirectly controlling . . . the issuer." The result is also justified where the person's affiliation arises from the other two situations contemplated by the last sentence in section 2(11).

A person who is controlled by an issuer is subject to manipulation by the issuer. By hypothesis, an issuer can cause a controlled person to file a registration statement for the public sale of securities issued by the controlled person. A controlled person (*e.g.*, a majority owned subsidiary) can also effect a secondary distribution, but only if the issuer approves. Consequently, the two persons are treated alike and the issuer is not free to accomplish indirectly what it is prohibited from doing directly. The other category of affiliate, a person under common control with an issuer, is considered a section 2(11) issuer because of his relationship with a person who controls the issuer. A person under common control with an issuer has a disability that is shared by a person controlled by an issuer, *i.e.*, he cannot effect a secondary distribution without the prior consent of the control person. Since a control person also controls an issuer, it is not unfair to insist that the person under common control file a registration statement before publicly reselling securities of an issuer.

The theoretical basis of the test for determining whether a control person constitutes a section 2(11) issuer seems clear and convincing. In practice, the test has suffered in two respects. First, it is narrow in scope. Certain persons who are not in a position to cause an issuer to file a registration statement can, nonetheless, disrupt the ordinary trading market in an issuer's securities by selling a significant amount of securities to the public. For some courts and, at times, the Commission itself, the inquiry is not whether a person has the ability to force an issuer to sign a registration statement, but whether he has the power to influence an issuer's business policies. The SEC staff regularly employs a more flexible standard for determining affiliation in responding to inquiries from attorneys and others who seek no-action treatment for a proposed sale under section 4(1) or rule 144.²⁸⁰ Second, the concept of control that

277. H.R. REP. NO. 85, 73d Cong., 1st Sess. 14 (1933).

278. The pragmatic test was suggested by Throop & Lane, *Some Problems of Exemption Under the Securities Act of 1933*, 4 LAW & CONTEMP. PROB. 89, 118 (1937).

279. See generally Sommer, *Who's In Control?—SEC*, 21 BUS. LAW. 559 (1966); Campbell, *Defining Control in Secondary Distributions*, 18 B.C. IND. & COM. L. REV. 37 (1976).

280. See 7B J.W. HICKS, *supra* note 26, § 10.05[1].

is embodied in section 2(11) is vague²⁸¹ and the factors that are used for determining the existence of control are imprecise.²⁸² Administrative guidance in the form of Rule 405 offers little assistance in deciding particular cases.²⁸³ As noted in the Wheat Report:

[C]ontrol of a company may arise from a combination of factors and the significance of most of these may vary from case to case, depending not only on the presence or absence of certain relationships but also upon the particular circumstances of the company and of the persons having an interest in it. The factors which would determine who is in control of General Motors would be far different from the factors which would determine who is in control of a small over-the-counter company; and even among similar companies, which case may present different relationships, corporate structures and managerial pattern.²⁸⁴

The Commission has never formally defined the phrase "any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer" in section 2(11) for purposes of secondary distributions of unregistered securities. The Commission has formulated rule 405, however, a definition of the term control, including the terms "controlling," "controlled by," and "under common control with." The definitional rule is incorporated into Regulation C, a collection of rules that govern every registration of securities under the Act.²⁸⁵ Under rule 405, control means "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."²⁸⁶ Under this definition, it is the existence of, rather than the exercise of, the power that is the crucial factor. Control may turn on "the latent ability to exercise a dominant influence over the affairs of the controlled person."²⁸⁷ The rule also makes it clear that the power to direct or cause the direction of the management and

281. The constitutionality of the control concept in § 2(11) was challenged in *United States v. Wolfson*, 405 F.2d 779, 783 (2d Cir. 1968), *cert. denied*, 394 U.S. 946 (1969), where the court dismissed the argument:

It will suffice to say that the appellants' defense was not that they misunderstood or misinterpreted the statute but that it was beneath their notice and they knew nothing about it. Under these circumstances we need say no more than that any possible uncertainty in the statute need not trouble us now. There will be time enough to consider that question when raised by someone whom it concerns.

The appellants' defense, by which they attempted to demonstrate a lack of intent to violate the law, was that they were unaware of any registration requirement with respect to stock of unlisted companies and that because they operated at such high levels of corporate finance, they could not be concerned about such "details." See also *United States v. Re*, 336 F.2d 306, 316 (2d Cir.), *cert. denied*, 379 U.S. 904 (1964), where the court rejected the contention that the concept of control in § 2(11) is unconstitutionally vague, stating: "The meaning of 'control' under the act is no different than it is in normal everyday usage. 'The requirement of reasonable certainty does not preclude the use of ordinary terms to express ideas which find adequate interpretation in common usage and understanding.'"

282. Congress was aware of the problem of defining "control," at least in the context of the Securities Exchange Act of 1934:

It would be difficult if not impossible to enumerate or to anticipate the many ways in which actual control may be exerted. A few examples of the methods used are stock ownership, lease, contract, and agency. It is well known that actual control sometimes may be exerted through ownership of much less than a majority of the stock of a corporation either by the ownership of such stock alone or through such ownership in combination with other factors.

H.R. REP. NO. 1383, 73d Cong., 2d Sess. 26 (1934).

283. 17 C.F.R. § 230.405 (1987) [hereinafter rule 405].

284. Wheat Report, *supra* note 12, at 158.

285. 17 C.F.R. §§ 230.400-499 (1987).

286. 17 C.F.R. § 230.405 (1987).

287. *In re Telescript-CSP Inc.*, 41 S.E.C. 664, 667 (1963).

policies of a person can stem from (1) the ownership of voting securities, (2) a contract, or (3) "otherwise."

Although rule 405 was not intended as an interpretation of the operative phrase in the second sentence of section 2(11), the Commission has utilized it for that purpose in its administrative proceedings.²⁸⁸ It also invokes rule 405 as the appropriate source for determining a person's status as an affiliate for purposes of rule 144.²⁸⁹ The use of rule 405 by the SEC and its staff in the context of section 2(11) would hardly merit comment were it not for the fact that in doing so it has neglected the qualification of control suggested by the legislative history. Instead of asking whether a person has the power to cause the issuer to file a registration statement, the SEC's inquiry is whether a person has the power to direct or cause the direction of "the management and policies of person."²⁹⁰ In many cases, the answer to the specific inquiry intended by Congress will be implicit in the answer to rule 405's broader question. In some cases, it will not.

It might be expected that judicial interpretations of the second sentence in section 2(11) have set the record straight but, unfortunately, they are not uniform.²⁹¹ For purposes of analysis they can be grouped into three classes. In the first group are those decisions that indicate as the basis for finding a particular person in control of an issuer that he was in a position to obtain the required signatures of the issuer and its officers and directors on a registration statement.²⁹² In a second group of decisions the determination of control under section 2(11) is reported without any statement of the applicable legal standard.²⁹³ In the third group are those decisions where the courts have justified a finding that an individual qualifies as a section 2(11) affiliate

288. *Id.*

289. American Standard, SEC No-action Letter [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,071, at 82,313 (Oct. 4, 1972).

290. 17 C.F.R. § 230.405 (1987).

291. See, e.g., SEC v. Computronic Indus. Corp., 294 F. Supp. 1136, 1139 (N.D. Tex. 1968), where the court construed § 2(11) and rule 405: "Under the aegis of Section 19(a) of the Securities Act of 1933 . . . the Commission defined 'control' and all its derivations to include at the very least any officer or director of the issuer."

292. See Pennaluna & Co. v. SEC, 410 F.2d 861, 865-66 (9th Cir. 1969), *cert. denied*, 396 U.S. 1007 (1970); SEC v. International Chem. Dev. Corp., 469 F.2d 20, 28 (10th Cir. 1972); SEC v. American Beryllium & Oil Corp., 303 F. Supp. 912, 915 (S.D.N.Y. 1969); SEC v. North Am. Research & Dev. Corp., 280 F. Supp. 106, 121 (S.D.N.Y. 1968), *modified*, 424 F.2d 63 (2d Cir. 1970); SEC v. Micro-Moisture Controls, 148 F. Supp. 558, 562 (S.D.N.Y. 1957), *permanent injunction*, 167 F. Supp. 716 (S.D.N.Y. 1958), *aff'd sub nom.*, SEC v. Culpepper, 270 F.2d 241 (2d Cir. 1959). In Wassel v. Eglowsky, 399 F. Supp. 1330, 1362 (D. Md. 1975), *aff'd*, 542 F.2d 1235 (4th Cir. 1976), the court relied on this test to find the requisite control for purposes of § 2(11). The court based its finding on the fact that the individual involved had directly participated in (1) the reorganization of the issuer, (2) the change of its management, (3) the removal of restrictive legends on certain of its stock certificates, and (4) the creation of an over-the-counter market in the stock.

293. See SEC v. Netelkos, 592 F. Supp. 906, 913-15 (S.D.N.Y. 1984), where the court found the following two individuals to be in control of the issuer, Falcon Sciences, Inc., because each "possessed and exercised the power to direct the management and policies" of the issuer: (1) Netelkos was an active participant in the day-to-day operation of Falcon and attended virtually every meeting of Falcon's board of directors, despite the fact that he had no official position on the board, and (2) Gamarekian; as to whom the court found:

His involvement with Falcon was extensive and included complete control over Falcon's stock transfer operations, management of Falcon's EOR field testing, supply purchases for those tests, and substantially all the contracts between Falcon and the market-makers of Falcon's stock. At a company the size of Falcon, control over this variety of significant work functions constitutes substantial control over the entire corporation.

Id. at 914-15. See also SEC v. Antoine Silver Mines, Ltd., 299 F. Supp. 414, 416 (N.D. Ill. 1968); United States v. Sherwood, 175 F. Supp. 480, 483 (S.D.N.Y. 1959); SEC v. Micro-Moisture Controls, 167 F. Supp. 716, 738 (S.D.N.Y. 1958).

by noting the relevance of one or more of the traditional indicia of control under rule 405.²⁹⁴ In all but the first group of decisions, it is impossible to ascertain from the written opinions whether the courts have faithfully adhered to the limited test for control that Congress intended for section 2(11).

D. *The Bottom Line: Investor Protection and Fewer Restraints*

The thesis of this Article is that the nature of a securities transaction determines the form of regulation and that the validity and scope of any resale limitation must be judged by the function it serves in furthering statutorily based regulation of that transaction. If this standard were applied to the present resale limitation policy, some restraints would continue to regulate resales in appropriate instances although their scope might be diminished: the holding period and coming to rest requirements and, for affiliates only, the conditions of rule 144 and the manner of sale limits of section 4(1-1/2). Many restraints on resales by nonaffiliates would disappear: the volume controls under the various forms of the presumptive underwriter doctrine, rule 145(c) and (d), all of the conditions of rule 144, other than paragraph (d), and any limitations on private sales of restricted securities after an adequate period of retention. The issue remains whether these relaxations would jeopardize public confidence in our securities markets and reduce investor protection in unregistered offerings.

Resale limitation policy, if reformed under the proposed criteria, would leave intact all of the major restraints on unregistered distributions, direct or indirect, by an issuer or an affiliate. The thrust of the practical implications of the thesis is confined to resales by nonaffiliates. Even if this category of seller is expanded, as it would under a definition of affiliate that conforms to legislative intent,²⁹⁵ public resales of restricted securities by nonaffiliates without direct rule 144-type restraints would not leave public investors unprotected. Anticipated problems of general solicitation or advertising, extra compensation, and insufficient disclosure concerning the issuer would have their greatest impact on resales effected through brokers. The SEC already has exercised authority under the 1934 Act to address each of these concerns with specific broker-dealer regulations.²⁹⁶ If necessary the SEC or the NASD could

294. See *SEC v. National Bankers Life Ins. Co.*, 334 F. Supp. 444, 455 (N.D. Tex. 1971), *aff'd*, 477 F.2d 920 (5th Cir. 1973), where the court stated that the "indicia of control evidenced by the defendants included stock ownership, directorship positions, officerships, family ties, creditor positions and 'dominating persuasiveness.'" "In the following cases, the courts' findings of control under § 2(11) were supported by a citation to Rule 405: *SEC v. Culpepper*, 270 F.2d 241, 245-46 (2d Cir. 1959); *SEC v. Computronic Indus. Corp.*, 294 F. Supp. 1136, 1139 (N.D. Tex. 1968); *SEC v. Bond & Share Corp.*, 229 F. Supp. 88, 95 (W.D. Okla. 1963). In *SEC v. Sherwood*, 175 F. Supp. 480, 483 (S.D.N.Y. 1959), the court rejected the Commission's claim that Sherwood was a control person at the time he resold unregistered securities. "[A]lthough Sherwood dominated 8% of the total issued stock, he was unable to secure a representation on the board of directors, he had a falling-out with John Christopher Doyle, who appears to have been the dominant figure in the management of [the issuer] and Sherwood was unable to free the bulls of his shares for distribution until Doyle consented thereto."

295. See *supra* text accompanying note 278.

296. 17 C.F.R. §§ 240.10(b) (5) (general antifraud), 10(b) (10) (disclosure of commission where broker-dealer acts as agent), 15c1-2 (antifraud rule as to broker-dealer in over-the-counter markets), & 15c2-11 (1987) (minimal information concerning issuer required before broker-dealer may enter quotation on an over-the-counter security). See also *Etlinger v. Merrill Lynch, Pierce, Fenner & Smith*, 835 F.2d 1031, 1033-36 (3d Cir. 1987), where the court held that a broker-dealer's failure to disclose commissions on the sale of zero-coupon bonds constituted a violation of rule 10b-5 and that the claim was not precluded by rule 10b-10.

adopt additional guidelines or controls that would apply directly to broker-dealers.²⁹⁷ As for the absence of volume controls on these securities, many transactions that do not meet the quantity limits of rule 144(e) are executed daily in the retail markets without disruptions in ordinary trading or indications of manipulation. Some issuers and other sellers undoubtedly claim exemptions for transactions that, although in technical compliance with their conditions, are part of a plan to evade the registration provisions of the Act. It is even possible that a liberalized resale limitation policy would increase the incidence of schemes. But invalid resale restraints that burden innocent market participants as well should not be used to curb these abuses, especially when other enforcement tools, specifically designed for these concerns, can be deployed directly against the violators.

A resale policy that is structured within the guidelines suggested here would produce more advantages than the obvious reduction of costly restraints on securities transactions and the resulting economic benefits. It would eliminate some of the complexity in the law that has confounded not only those who must interpret it but also those who attempt to comply with its demands. It would reduce the risk of violation for nonaffiliates whose resales must satisfy numerous restraints under rule 144 if the section 4(1) trading exemption is to apply. It would remove from ordinary securityholders the *in terrorem* effect of section 12(1) and the various administrative sanctions that Congress intended primarily for issuers and affiliates. It would reflect the relatively narrow mission of the 1933 Act and leave to regulatory policy rooted in the broader based 1934 Act the task of governing securities professionals and secondary trading. Finally, it would move closer to striking a proper balance between public protection and securityholder freedom.

297. The National Association of Securities Dealers (NASD) is the self-policing organization to which the vast majority of brokers or dealers belong. It adopts rules and guidelines that supplement SEC regulation. *See, e.g.*, NASD Man. (CCH) ¶ 2154 (Mar. 1988) (the so-called 5% mark-up policy). *See generally* L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 689-94 (1983); Cary, *Self-Regulation in the Securities Industry*, 49 A.B.A. J. 244 (1963).